Predictable Forward Performance Processes:  
The Binomial Case *

Bahman Angoshtari† Thaleia Zariphopoulou‡ Xun Yu Zhou§

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Abstract

We introduce a new class of forward performance processes that are endogenous and predictable with regards to an underlying market information set and, furthermore, are updated at discrete times. We analyze in detail a binomial model whose parameters are random and updated dynamically as the market evolves. We show that the key step in the construction of the associated predictable forward performance process is to solve a single-period inverse investment problem, namely, to determine, period-by-period and conditionally on the current market information, the end-time utility function from a given initial-time value function. We reduce this inverse problem to solving a functional equation and establish conditions for the existence and uniqueness of its solutions in the class of inverse marginal functions.

Keywords: Portfolio selection, forward performance processes, binomial model, inverse investment problem, functional equation, predictability.

1 Introduction

The classical portfolio selection paradigm is based on three fundamental ingredients: a given investment horizon, \([0, T]\), a performance function (such as a utility or a risk-return trade-off), \(U_T(\cdot)\), applied at the end of the horizon, and a market model which yields the random investment opportunities available over \([0, T]\). This triplet is exogenously and entirely specified at initial time, \(t = 0\).

Once these ingredients are chosen, one then solves for the optimal strategy \(\pi^*(\cdot)\), and derives the value function \(U_0(\cdot)\) at \(t = 0\) as the expectation of the terminal utility of optimal

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†Department of Applied Mathematics, University of Washington. Email: bahmang@uw.edu.

‡Departments of Mathematics and IROM, The University of Texas at Austin, Austin and the Oxford-Man Institute, University of Oxford, Oxford, UK. Email: zariphop@math.utexas.edu.

§Department of IEOR, Columbia University, New York, NY 10027. Email: xz2574@columbia.edu.
wealth. The value function thus stipulates the best possible performance value achievable from each and every amount of initial wealth and, hence, it can be in turn considered as a performance criterion at \( t = 0 \) that is consistent with the terminal performance criterion \( U_T(\cdot) \). Here, \( U_T(\cdot) \) is exogenous, and \( \pi^*(\cdot) \) and \( U_0(\cdot) \) are endogenous. The model therefore entails a backward approach in time, from \( U_T(\cdot) \) to \( U_0(\cdot) \). This is also in accordance with the celebrated Dynamic Programming Principle (DPP) or, otherwise, known as Bellman’s principle of optimality.

Despite its classical mathematical foundations and theoretical appeal, this approach nonetheless has several shortcomings. Firstly, it relies heavily on the model selection for the entire investment horizon, which is not practical, especially if the horizon is long. The second difficulty is the pre-commitment, at the initial time, to a terminal utility. Indeed, it is clearly difficult to assess and specify the performance function when the investment horizon is sufficiently long. Moreover, a performance criterion naturally depends on time and state (either state of nature or state of an agent’s circumstances). It is more plausible that one knows the utility or the resulting preferred allocations for now or the immediate future, and then preserve them under certain consistency criteria (see, for example, the old note of Fischer Black, Black (1988)). Thirdly, it is very seldom the case that an optimal investment problem “terminates” at a single horizon \( T \) or whether \( T \) is a priori known when the investment activity is firstly set.

The above considerations have led to the development of the so-called forward performance measurement, initially proposed by Musiela and Zariphopoulou (2006) and later extended by the same authors in a series of papers (see Musiela and Zariphopoulou (2009, 2010a,b, 2011)) and by others (see El Karoui and Mrad (2013), and Nadtochiy and Tehranchi (2017)) in continuous-time market settings. The main idea of the forward approach is that instead of fixing, as in the classical setting, an investment horizon, a market model and a terminal utility, one starts with an initial performance measurement and updates it forward in time as the market and other underlying stochastic factors evolve. The evolution of the forward process is dictated by a forward-in-time version of the DPP and, thus, it ensures time-consistency across all different times.

Most of the existing results on forward performance measurement have so far focused exclusively on continuous-time, Itô-diffusion settings, in which both trading and performance valuation are carried out continuously in time. It was shown in Musiela and Zariphopoulou (2010a) that the forward process is associated with an ill-posed infinite-dimensional stochastic partial differential equation (SPDE), the same way that the classical value function satisfies the finite-dimensional Hamilton-Jacobi-Bellman equation (HJB). This performance SPDE has been subsequently studied in El Karoui and Mrad (2013), Nadtochiy and Zariphopoulou (2014), Nadtochiy and Tehranchi (2017) and, more recently, in Shkolnikov et al. (2016) for asset price factors evolving at different time scales. Despite the technical challenges that this forward SPDE presents (ill-posedness, high or infinite dimensionality, degeneracies, and volatility specification), the continuous-time cases are tractable because stochastic calculus can be employed and infinitesimal arguments can be, in turn, developed.

However, the continuous-time setting has a major drawback in that it is hard to see how exactly the performance criterion evolves from one instant to the next. This evolution is lost at the infinitesimal level and hidden behind the (generally intractable) stochastic PDE.

The aim of this paper is to introduce and study forward investment performance processes that are discrete in time, while trading can be either discrete or continuous in time. We will develop an iterative mechanism through which an investor updates/predicts her performance
criterion at the next investment period, based on both her current performance and her assessment of the upcoming market dynamics in the next period. This predictability will be present in an explicit and transparent manner.

In addition to the conceptual motivation described above, there are also practical considerations in studying the discrete-time predictable forward performance. Indeed, in investment practice, trading occurs at discrete times and not continuously. More importantly, typically performance criteria are directly or indirectly determined by individuals, such as higher-level managers or clients, and not by the portfolio manager. These “performance evaluators” use information sets that are different, both in terms of content and updating frequency, from the ones used by the portfolio manager. Moreover, even if trading can occur at extremely high frequencies (hence almost close to continuous trading), performance assessment/update takes place at a much slower pace, e.g., a senior manager will not keep track of the performance of a portfolio or update the performance criterion as frequently as the subordinate portfolio manager in charge of that portfolio.

In this paper, we will consider a (possibly indefinite) series of time points, \(0 = t_0, t_1, \ldots, t_n, \ldots\), at which the performance measurement is evaluated and updated. The (short) period between any given two neighboring points will be called an evaluation period. We define our forward performance processes in a completely analogous way to the continuous-time counterparts. However, we choose to work with processes that are predictable with regards to the information at the most recent evaluation time. We elaborate on this requirement later on.

To highlight the key ideas of predictable forward performance processes, we start our analysis with a simple, yet still rich enough setting. The market consists of two securities, a riskless asset and a stock whose price evolves according to a binomial model at times \(0 = t_0, t_1, \ldots, t_n, \ldots\), at which the forward performance evaluation also occurs. The market model is more general than the standard binomial tree, in that the asset returns and their probabilities are estimated/determined only one period ahead. Such a setting allows for “real-time” dynamic updating of the underlying parameters, as the market evolves from one period to the next.

The definition of a discrete-time predictable forward performance process (see Definition 1) dictates that in each evaluation period \([t_n, t_{n+1})\), the initial performance function \(U_n(\cdot)\) is nothing else than the value function of an expected utility maximization problem in this period with \(U_{n+1}(\cdot)\) being the terminal utility function. Therefore, in generating a predictable forward performance process, we need to solve, in each period, an investment problem where the value function is given and the terminal utility function is to be found. This problem, which we term a single-period inverse investment problem, then needs to be solved sequentially “period-by-period,” conditionally on the dynamically updated information at the beginning of this period. It turns out that the key to solving this problem is a linear functional equation, which relates the inverse marginal processes at the beginning and the end of each evaluation period. We analyze this equation in detail, and establish conditions for existence and uniqueness of the solutions in the class of inverse marginal functions.

Once such a single-period inverse investment is solved, then starting from \([0, t_1)\) and proceeding iteratively forward in time, a predictable performance process is constructed together with the optimal allocations and their wealth processes.\(^1\)

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\(^1\)In this paper we assume that both the updating and trading take place at the same time. As discussed above, this does not have to be the case. However, we choose to study this parsimonious model in order to
The paper is structured as follows. In Section 2, we introduce the notion of predictable forward performance processes in a general market setting. We then formulate a binomial model with random, dynamically updated parameters, in Section 3. In Section 4, we apply the definition of predictable forward performance processes to the binomial model, and show that their construction reduces to solving an inverse investment problem. In Section 5, this inverse problem is shown to be equivalent to solving a functional equation. We derive sufficient existence and uniqueness conditions as well as the explicit solution to the functional equation in Section 6. Finally, we present the general construction algorithm in Section 7, and conclude in Section 8. Proofs of the main results are relegated to an Appendix.

2 Predictable forward performance processes: A general definition

In this section, we introduce the concept of discrete-time predictable forward performance processes in a general market model. Starting from the next section, we will restrict the market setting to a binomial model with random, dynamically updated parameters, and provide a detailed discussion on the existence and construction of such performance processes.

The investment paradigm is cast in a probability space \((\Omega, \mathcal{F}, P)\) augmented with a filtration \((\mathcal{F}_t)\), \(t \geq 0\). We denote by \(X(0, x)\) the set of all the admissible wealth processes \(X_s, s \geq t\), starting with \(X_t = x\) and such that \(X_s\) is \(\mathcal{F}_s\)-measurable. The term “admissible” is for now generic and will be specified once a specific market model is introduced in the sequel.

We call a function \(U : \mathbb{R}^+ \rightarrow \mathbb{R}^+\) a utility (or performance) function if \(U \in C^2(\mathbb{R}^+)\), \(U' > 0, U'' < 0\), and satisfies the Inada conditions, \(\lim_{x \to 0^+} U'(x) = \infty\) and \(\lim_{x \to \infty} U'(x) = 0\).

For any \(\sigma\)-algebra \(\mathcal{G} \subseteq \mathcal{F}\), the set of \(\mathcal{G}\)-measurable utility (or performance) functions is defined as

\[
\mathcal{U}(\mathcal{G}) = \{U : \mathbb{R}^+ \times \Omega \to \mathbb{R} \mid U(x, \cdot) \text{ is } \mathcal{G} \text{-measurable for each } x \in \mathbb{R}^+, \text{ and } U(\cdot, \omega) \text{ is a utility function a.s.}\}.
\]

In other words, the elements of \(\mathcal{U}(\mathcal{G})\) are entirely known (predicted) based on \(\mathcal{G}\), as they are predictable with regards to the information contained in \(\mathcal{G}\). Alternatively, we may think of \(U \in \mathcal{U}(\mathcal{G})\) as a deterministic utility function, given the information in \(\mathcal{G}\).

Next, we define the discrete predictable forward performance processes. To ease the notation, we skip the \(\omega\)-argument throughout.

**Definition 1.** Let discrete time points \(0 = t_0 < t_1 < \cdots < t_n < \cdots\) be given. A family of random functions \(\{U_0, U_1, U_2, \cdots\}\) is a predictable forward performance process with respect to \((\mathcal{F}_t)\) if, for \(X_n = X_{t_n}\) and \(\mathcal{F}_n = \mathcal{F}_{t_n}, n = 0, 1, 2, \ldots\), the following conditions hold:

(i) \(U_0\) is a deterministic utility function and \(U_n \in \mathcal{U}(\mathcal{F}_{n-1})\).

(ii) For any initial wealth \(x > 0\) and any admissible wealth process \(X = \{X_n\}_{n=0}^\infty \in \mathcal{X}(0, x)\),

\[
U_{n-1}(X_{n-1}) \geq E_P[U_n(X_n) \mid \mathcal{F}_{n-1}].
\]

highlight the significance of updating the performance measurement in discrete times, without getting into too much technicality.
(iii) For any initial wealth \( x > 0 \), there exists an admissible wealth process \( X^* = \{X^*_n\}_{n=0}^\infty \in \mathcal{X}(0, x) \) such that
\[
U_{n-1} \left( X^*_{n-1} \right) = \mathbb{E}_P \left[ U_n \left( X^*_n \right) \mid \mathcal{F}_{n-1} \right].
\]

This definition is analogous to its continuous-time counterpart (see Musiela and Zariphopoulou (2009)), except condition (i). This condition is superfluous in a continuous-time model, but fundamental in a discrete-time one. It explicitly requires that the performance function at the next upcoming assessment time is entirely determined from the information up to the present time (hence the name “predictable forward”).

On the other hand, as in the continuous-time case, properties (ii)-(iii) draw from Bellman’s principle of optimality, which stipulates that the processes \( U_n(X_n) \) and \( U_n(X^*_n) \), \( n = 0, 1, \ldots \), are, respectively, a supermartingale and a martingale with respect to the filtration \( (\mathcal{F}_n) \). Since the Bellman principle underlines time-consistency, properties (ii)-(iii) directly ensure that the investment problem is time-consistent under the predictable forward performance criterion.

Hence, the above performance measurement is essentially endogenized by the time-consistency requirements (ii)-(iii).\(^2\)

Definition 1 already suggests a general scheme for constructing predictable forward performance functions in discrete times. Indeed, starting from an initial datum \( U_0 \), given at time \( t_0 = 0 \), the entire family \( U_1, \ldots, U_n, \ldots \), can be obtained by determining \( U_n \) from \( U_{n-1} \) iteratively, \( n = 1, 2, \ldots \), in the way described below.

Properties (ii)-(iii) dictate that, for each trading period \([t_{n-1}, t_n]\), we have
\[
U_{n-1} \left( X^*_{n-1} \right) = \sup_{X_n \in \mathcal{X}(t_{n-1}, X^*_n)} \mathbb{E}_P \left[ U_n(X_n) \mid \mathcal{F}_{n-1} \right]. \tag{1}
\]

At instant \( t_{n-1} \), since \( \mathcal{F}_{n-1} \) is realized, the random functions \( U_{n-1} \) and \( U_n \) are both deterministic and so is \( X^*_{n-1} \). This, in turn, suggests that we should consider the following “single-period” investment problem (conditional on \( \mathcal{F}_{n-1} \)):
\[
U_{n-1}(x) = \sup_{X_n \in \mathcal{X}_{n-1, n}(x)} \mathbb{E}_P \left[ U_n(X_n) \right], \tag{2}
\]
for \( x > 0 \), where, with a slight abuse of notation, we use \( \mathcal{X}_{n-1, n}(x) \) to denote the set of admissible wealths at \( t_n \) starting at \( t_{n-1} \) with wealth \( x \).

Therefore, if we are able to determine, for each \( n = 1, 2, \ldots \), a performance function \( U_n \in \mathcal{U}(\mathcal{F}_{n-1}) \), such that the pair \((U_{n-1}, U_n)\) satisfies (2), then we will have an iterative scheme to construct the entire predictable forward performance process, starting from \( U_0 \).

One readily recognizes that (2) would be the classical expected utility problem if the objective were to derive \( U_{n-1} \) from \( U_n \), with \( U_n \) being a deterministic utility function. Therefore, what we consider now is an inverse investment problem in that we are given its initial value function and we seek a terminal utility that is consistent with the latter, with both of these functions being deterministic (conditionally on \( \mathcal{F}_{n-1} \)).

\(^2\)Note that the predictability of risk preferences is implicitly present in the classical expected utility in finite horizon settings, say \([0, T]\), in which a deterministic utility for \( T \) is pre-chosen at initial time \( t_0 = 0 \), and it is thus \( \mathcal{F}_0 \)-measurable. The fundamental difference, however, is that the terminal utility function in the classical theory is exogenous, instead of endogenous.
We give the following very important observation. Definition 1 of the predictable forward criterion might at first indicate that we need to choose the full model at $t_0 = 0$, in that we need to completely specify both the levels of the stock return process and the related probabilities for all future times $t_1, t_2, \ldots$. As mentioned earlier, this is a very stringent requirement in the traditional framework. However, this is not the case in the forward setting.

Indeed, as the analysis will show, in order to construct the predictable forward criterion and the associated optimal portfolios and wealths, we only need to know at the beginning of each period, say $[t_{n-1}, t_n)$, the transition probabilities, $p_n$, and the values $u_n, d_n$ of the return $R_n$. In other words, we only need to specify at $t_{n-1}$ the single-step model input $(p_n, u_n, d_n)$.

This triplet is thus $\mathcal{F}_{n-1}$-measurable and, as such, it captures accurately and in “real-time” the evolution of the market in $(0, t_{n-1}]$. There is no need to specify at $t_{n-1}$ any model input beyond $(p_n, u_n, d_n)$.

Herein, we are not concerned with the specific mechanism that yields the model input $(p_n, u_n, d_n)$ at $\mathcal{F}_{t-1}$. It may be the outcome of a dynamic sequential learning procedure or it may be provided exogenously from a specialist, etc. The crucial point is that there is no requirement that it is a priori modeled.

To the best of our knowledge, such inverse discrete-time problems have not been considered in the literature. We start in this paper with the binomial case in which the parameters - including the transition probabilities and price levels - are not known a priori but are updated period-by-period as the market moves. As we will see, while the binomial case is one of the simplest discrete-time market models, its analysis is sufficiently rich and its results reveal the key economic insights regarding the predictable forward performance criteria.

3 A binomial market model with random, dynamically updated parameters

We consider a market with two traded assets, a riskless bond and a stock. The bond is taken to be the numeraire and assumed, without loss of generality, to offer zero interest rate. The stock price at times $t_0, t_1, \ldots$, evolves according to a binomial model that we now specify.

Let $R_n$ be the total return of the stock over period $[t_{n-1}, t_n)$. Here, $R_n$ is a random variable with two values $u_n > d_n$. We assume that $R_n, u_n$, and $d_n$, $n = 1, 2, \ldots$, are all random variables in a measurable space $(\Omega, \mathcal{F})$ augmented with a filtration $(\mathcal{F}_n)$, $n = 1, 2, \ldots$, with $\mathcal{F}_n$ representing the information available at $t_n$. Moreover, we assume that $R_n$ is $\mathcal{F}_n$-measurable and that its values, $u_n$, and $d_n$, are $\mathcal{F}_{n-1}$-measurable. In other words, the high and low return levels for each investment period are known at the beginning of this period, while the realized return is known at its end.

The historical measure $\mathbb{P}$ is a probability measure on $(\Omega, \mathcal{F})$ and the following standard no-arbitrage conditions are satisfied. As mentioned earlier, the specific values of the transition probabilities, say $p_1, p_2, \ldots$, are not a priori specified at $t_0 = 0$. Rather, it is assumed that they are provided at the beginning of the corresponding trading period, namely, in the trading period $[t_{n-1}, t_n)$, $p_n$ is provided at $t_{n-1}$ and as such it is $\mathcal{F}_{n-1}$-measurable. The only standing assumption (see (ii) below) is that these probabilities satisfy the natural no arbitrage conditions.
Assumption 2. For all $n = 1, 2, \ldots$:

(i) $0 < d_n < 1 < u_n$, $\mathbb{P}$-a.s.,

(ii) The transition probabilities $p_n$ satisfy $0 < p_n < 1$.

As mentioned earlier we are not concerned herein with how the $\mathcal{F}_{n-1}$-measurable model input $(p_n, u_n, d_n)$ is acquired at $t_{n-1}$. It may, for example, be the outcome of an independent sequential learning procedure.

The investor trades between the stock and the bond using self-financing strategies. She starts at $t_0 = 0$ with total wealth $x > 0$ and rebalances her portfolio at times $t_n, n = 1, 2, \ldots$. At the beginning of each period, say $[t_n, t_{n+1})$, she chooses the amount $\pi_{n+1}$ to be invested in the stock (and the rest in the bond) for this period. In turn, her wealth process, denoted by $X^\pi_n, n = 1, 2, \ldots$, evolves according to the wealth equation

$$X^\pi_{n+1} = X^\pi_n + \pi_{n+1}(R_{n+1} - 1),$$

with $X_0 = x$.

The investor is allowed to short the stock but her wealth can never become negative; thus, $\pi_{n+1}$ must satisfy

$$-\frac{X^\pi_n}{u_{n+1} - 1} \leq \pi_{n+1} \leq \frac{X^\pi_n}{1 - d_{n+1}}; \quad n = 1, 2, \ldots \quad (3)$$

We call an investment strategy $\pi = \{\pi_n\}_{n=1}^\infty$ admissible if it is self-financing, $\pi_n$ is $\mathcal{F}_{n-1}$-measurable, and (3) is satisfied $\mathbb{P}$-a.s. A wealth process $X = \{X^\pi_n\}_{n=0}^\infty$ is then admissible if the strategy $\pi$ that generates it is admissible.

We recall that $\mathcal{X}(n, x)$ is the set of admissible wealth processes $\{X_m\}_{m=n}^\infty$, starting with $X_n = x$.

We also introduce the auxiliary “single-step” set of admissible portfolios $\pi_{n+1}$, chosen at $t_n$ for the trading period $[t_n, t_{n+1})$ and assuming wealth $x$ at $t_n$, by

$$\mathcal{A}_{n,n+1}(x) = \left\{ \pi_{n+1} : \pi_{n+1} \text{ is } \mathcal{F}_n\text{-measurable, } -\frac{x}{u_{n+1} - 1} \leq \pi_{n+1} \leq \frac{x}{1 - d_{n+1}}, \quad x > 0 \right\},$$

as well as the corresponding set of admissible wealth processes

$$\mathcal{X}_{n,n+1}(x) = \{x + \pi_{n+1}R_{n+1} : \pi_{n+1} \in \mathcal{A}_{n,n+1}(x), \quad x > 0\}.$$

4 Problem statement and reduction to the single-period inverse investment problem

In this section, we consider predictable forward performance processes in the binomial model, and show that their construction reduces to solving a series of single-period inverse investment problems.

The investor starts with an initial utility $U_0$ and updates her performance criteria at times $t_1, t_2, \ldots$, with the associated performance functions $U_1, U_2, \ldots$ satisfying Definition 1.
We now present the procedure that yields the construction of a predictable forward performance process starting from $U_0$, and determining $U_n$ from $U_{n-1}$, iteratively for $n = 1, 2, \ldots$

At $t_0 = 0$, equation (1) becomes

$$U_0(x) = \sup_{x_1 \in \mathcal{X}(0,x)} E_{\mathbb{P}} \left[ U_1(X_1) \mid \mathcal{F}_0 \right] = \sup_{x_1 \in \mathcal{A}_{n-1}(x)} E_{\mathbb{P}} \left[ U_1(x + \pi_1(R_1 - 1)) \right]; \quad x > 0. \quad (4)$$

Since the market parameters $(u_1, d_1, p_1)$ and the initial datum $U_0$ are known at $t_0$, finding a deterministic ($\mathcal{F}_0$-measurable) $U_1$ reduces to the single-period inverse investment problem discussed in Section 2. Let us for the moment assume that we are able to solve this inverse problem to obtain $U_1$.

At $t = t_1$, the investor observes the realization of the stock return $R_1$ and estimates the parameters $(u_2, d_2, p_2)$ for the second trading period $[t_1, t_2)$. Setting $n = 2$ in (1) then yields

$$U_1(X_1^*(x)) = \sup_{x_2 \in \mathcal{X}(1,X_1^*(x))} E_{\mathbb{P}} \left[ U_2(X_2) \mid \mathcal{F}_1 \right], \quad (5)$$

where $X_1^*(x)$ is the optimal wealth generated at $t_1$, starting at $x$ at $t_0 = 0$, from the previous period.

It follows from the classical expected utility theory (see also Theorem 4 below) that $X_1^*(x) = I_1(\rho_1 U_0(x))$, $x > 0$, where $I_1 = (U_1')^{-1}$ and $\rho_1$ is the pricing kernel over the period $[0, t_1)$, given by

$$\rho_1 = \frac{1 - d_1}{p_1(u_1 - d_1)} 1_{\{R_1 = u_1\}} + \frac{u_1 - 1}{(1 - p_1)(u_1 - d_1)} 1_{\{R_1 = d_1\}}. \tag{5}$$

The mapping $x \rightarrow X_1^*(x)$ is strictly increasing for each $x > 0$ and of full range, since $I_1$ and $U_0$ are both strictly decreasing functions, $\rho_1 > 0$, and the Inada conditions yield $X_1^*(0) = 0$ and $X_1^*(\infty) = \infty$.

Since $X_1^*(x)$ is $\mathcal{F}_1$-measurable and the parameters $(u_2, d_2, p_2)$ together with $U_1$ are all known at $t = t_1$, we deduce that (5) reduces, with a slight abuse of notation, to finding $U_2(\cdot) \in \mathcal{U}(\mathcal{F}_1)$ such that

$$U_2(x) = \sup_{x_2 \in \mathcal{A}_{1,2}(x)} E_{\mathbb{P}} \left[ U_2(x + \pi_2(R_2 - 1)) \mid \mathcal{F}_1 \right]; \quad x > 0, \tag{6}$$

with $U_1$ given. In other words, one needs to solve yet another single-period inverse investment problem that is mathematically identical to (4).

At $t = t_n$, in exactly the same manner as above, we have to solve

$$U_n(x) = \sup_{x_{n+1} \in \mathcal{A}_{n,n+1}(x)} E_{\mathbb{P}} \left[ U_{n+1}(x + \pi_{n+1}(R_{n+1} - 1)) \mid \mathcal{F}_n \right]; \quad x > 0, \tag{7}$$

thereby deriving $U_{n+1}$ from $U_n$, with $U_{n+1} \in \mathcal{U}(\mathcal{F}_{n+1})$ and with the parameters $(u_n, d_n, p_n)$ known at $t_n$.

Thus, all the terms of a predictable forward performance process can be obtained, starting from an arbitrary initial wealth $x > 0$ and proceeding iteratively solving a “period-by-period” inverse optimization problem. Moreover, as we show in the next section, we also concurrently derive the optimal portfolio and wealth processes.

To summarize, the crucial step in the entire predictable forward construction is to solve this single-period inverse investment problem. We do this in the next section.
5 The single-period inverse investment problem

We focus on the analysis of the inverse investment problem (4). To ease the presentation, we introduce a simplified notation. We set \( t_0 = 0, t_1 = 1 \) and \( R_1 = R \) taking values \( u \) and \( d \), \( u > 1 \) and \( 0 < d < 1 \), with probability \( 0 < p < 1 \) and \( 1 - p \), respectively. We recall the risk neutral probabilities
\[
q = \frac{1 - d}{u - d} \quad \text{and} \quad 1 - q = \frac{u - 1}{u - d},
\]
and the pricing kernel
\[
\rho_1 = \rho^u 1_{\{R = u\}} + \rho^d 1_{\{R = d\}} := \frac{q}{p} 1_{\{R = u\}} + \frac{1 - q}{1 - p} 1_{\{R = d\}}. \tag{6}
\]

The investor starts with wealth \( X_0 = x > 0 \), and invests the amount \( \pi \) in the stock. Her wealth at \( t = 1 \) is then given by the random variable \( X = x + \pi(R - 1) \). The no-bankruptcy constraint (3) becomes \( \pi(x) \leq \pi \leq \pi(x), \) with
\[
\pi(x) = -\frac{x}{u - 1} < 0 \quad \text{and} \quad \pi(x) = \frac{x}{1 - d} > 0.
\]

We denote the set of admissible portfolios as
\[
\mathcal{A}(x) = \{ \pi \in \mathbb{R}, \text{ and } \pi(x) \leq \pi \leq \pi(x), \ x > 0 \}.
\]
Given an initial utility function \( U_0 \), we then seek a deterministic performance function \( U_1 \), such that
\[
U_0(x) = \sup_{\pi \in \mathcal{A}(x)} \mathbb{E}_\mathbb{P} [U_1(x + \pi(R - 1))]; \ x > 0. \tag{7}
\]

Let \( \mathcal{U} \) be the set of deterministic utility functions. We introduce the set of inverse marginal functions \( \mathcal{I} \),
\[
\mathcal{I} := \left\{ I \in C^1(\mathbb{R}^+) : I' < 0, \lim_{y \to -\infty} I(y) = 0, \lim_{y \to 0^+} I(y) = \infty \right\}. \tag{8}
\]
Note that if functions \( U \) and \( I \) satisfy \( I = (U')^{-1} \), then \( U \) is a utility function if and only if \( I \) is an inverse marginal function.

Assuming for now that a utility function \( U_1 \) satisfying (7) exists, we consider the inverse marginal functions
\[
I_0 = (U_0')^{-1} \quad \text{and} \quad I_1 = (U_1')^{-1}.
\]
Our main goal in this section is to show that the inverse investment problem (7) reduces to a functional equation in terms of \( I_0 \) and \( I_1 \); see (9) below.

The following theorem is one of the main results herein, establishing a direct relationship between the inverse marginals at the beginning and at the end of the trading period \([0, 1]\), when the corresponding utilities are related by (7).

**Theorem 3.** Let \( U_0, U_1 \in \mathcal{U} \) satisfy the optimization problem (7). Then, their inverse marginals \( I_0 \) and \( I_1 \) must satisfy the linear functional equation
\[
I_1(a y) + b I_1(y) = (1 + b) I_0(c y); \quad y > 0, \tag{9}
\]
where
\[
a = \frac{1 - p}{p} \frac{q}{1 - q}, \quad b = \frac{1 - q}{q} \quad \text{and} \quad c = \frac{1 - p}{1 - q}. \tag{10}
\]
\textit{Proof.} From standard arguments, we deduce that for all \( x > 0 \), there exists an optimizer \( \pi^*(x) \) for \((7)\) satisfying the first-order condition
\[
p(u-1)U'_1(x + \pi^*(x)(u-1)) + (1-p)U'_1(x + \pi^*(x)(d-1)) = 0. \tag{11}
\]
Indeed, let \( f(\pi) := \mathbb{E}[U_1(x + \pi(R-1))] \). By concavity of \( U_1(\cdot) \), one has
\[
f''(\pi) = \mathbb{E} \left[ (R-1)^2 U''_1(x + \pi(R-1)) \right] \leq 0; \quad \underline{\pi}(x) < \pi < \overline{\pi}(x).
\]
Furthermore,
\[
f'(\overline{\pi}(x)) = p(u-1)U'_1(0) + (1-p)(d-1)U'_1(x + \overline{\pi}(x)(d-1)) = +\infty
\]
and
\[
f'(\underline{\pi}(x)) = p(u-1)U'_1(x + \underline{\pi}(x)(u-1)) + (1-p)(d-1)U'_1(0) = -\infty.
\]
where we used the Inada condition \( U'_1(0) = +\infty \) and that \( x + \pi(x)(d-1) = x + \overline{\pi}(x)(u-1) = 0 \) by the definition \( \overline{\pi}(x) \) and \( \underline{\pi}(x) \). Therefore, for any \( x > 0 \), there exists a unique \( \pi^*(x) \in (\underline{\pi}(x), \overline{\pi}(x)) \) such that \( f'((\pi^*(x)) = 0 \), which is \((11)\).

On the other hand, it follows from \((7)\) that
\[
U_0(x) = pU_1(x + \pi^*(x)(u-1)) + (1-p)U_1(x + \pi^*(x)(d-1)).
\]
Differentiating the above equation yields
\[
U'_0(x) = pU'_1(x + \pi^*(x)(u-1)) + (1-p) U'_1(x + \pi^*(x)(d-1))
+ (\pi^*)'(x)(p(u-1)U'_1(x + \pi^*(x)(u-1)) + (1-p)U'_1(x + \pi^*(x)(d-1)))
\]
and, using \((11)\), one obtains
\[
U'_0(x) = pU'_1(x + \pi^*(x)(u-1)) + (1-p) U'_1(x + \pi^*(x)(d-1)). \tag{12}
\]
Solving the linear system \((11)-(12)\) gives
\[
U'_1(x + \pi^*(x)(u-1)) = \frac{(1-d)}{p(u-d)} U'_0(x)
\]
and
\[
U'_1(x + \pi^*(x)(d-1)) = \frac{(u-1)}{(1-p)(u-d)} U'_0(x).
\]
Therefore, the optimal allocation function \( \pi^*(x) \) satisfies
\[
\begin{aligned}
  x + \pi^*(x)(u-1) & = I_1 \left( \frac{1-d}{p(u-d)} U'_0(x) \right), \\
  x + \pi^*(x)(d-1) & = I_1 \left( \frac{u-1}{(1-p)(u-d)} U'_0(x) \right),
\end{aligned} \tag{13}
\]
from which we obtain the solution
\[
\pi^*(x) = \frac{1}{u-d} \left( I_1 \left( \frac{1-d}{p(u-d)} U'_0(x) \right) - I_1 \left( \frac{u-1}{(1-p)(u-d)} U'_0(x) \right) \right); \quad x > 0.
\]
Substituting the above in either of the equations in (13) yields
\[
\frac{1 - d}{u - d} I_1 \left( \frac{1 - d}{p(u - d)} U'_0(x) \right) + \frac{u - 1}{u - d} I_1 \left( \frac{u - 1}{(1 - p)(u - d)} U'_0(x) \right) = x.
\]
Changing variables \( x = I_0 \left( \frac{1 - d}{p(u - d)} y \right), \quad y > 0, \) the above becomes
\[
I_1 \left( \frac{(1 - p)(1 - d)}{p(u - d)} y \right) + \frac{u - 1}{1 - d} I_1(y) = \frac{u - d}{1 - d} I_0 \left( \frac{(1 - p)(u - d)}{u - 1} y \right); \quad y > 0.
\]
Noting (10) we conclude.

The next theorem shows how to recover \( U_1 \) from \( I_1 \) and derives the optimal portfolio \( \pi^*(x) \) and its wealth \( X^*(x) \).

**Theorem 4.** Let \( U_0 \) be a utility function and \( I_0 \) be its inverse marginal, and \( I_1 \) be an inverse marginal solving the functional equation (9). Let also \( \rho_1 \) be the pricing kernel given by (6). Then, the following statements hold.

(i) The function \( U_1 \) defined by
\[
U_1(x) := U_0(1) + E_\mathbb{P} \left[ \int_{I_1(\rho_1 U'_0(1))}^{\infty} I^{-1}_1(\xi) d\xi \right]; \quad x > 0,
\]
is a well-defined utility function.

(ii) We have
\[
U_0(x) = \sup_{\pi \in \mathcal{A}(x)} E_\mathbb{P} \left[ U_1(x + \pi(R - 1)) \right]; \quad x > 0.
\]

(iii) The optimal wealth \( X^*_1(x) \) and the associated optimal investment allocation \( \pi^*(x) \) are given, respectively, by
\[
X^*_1(x) = I_1(\rho_1 U'_0(x)) = X^{*,u}(x) 1_{\{R=u\}} + X^{*,d}(x) 1_{\{R=d\}}
\]
and
\[
\pi^*(x) = \frac{X^{*,u}(x) - X^{*,d}(x)}{u - d},
\]
with
\[
X^{*,u} = I_1 \left( \frac{q}{p} U'_0(x) \right) \quad \text{and} \quad X^{*,d} = I_1 \left( \frac{1 - q}{1 - p} U'_0(x) \right).
\]

**Proof.** See Appendix A.

**Remark 5.** As shown in the proof of Theorem 4, we can replace (14) with
\[
U_1(x) := U_0(c) + E_\mathbb{P} \left[ \int_{I_1(\rho_1 U'_0(c))}^{\infty} I^{-1}_1(\xi) d\xi \right]; \quad x > 0,
\]
for any arbitrary constant \( c > 0 \). The choice of \( c \) does not change the value of \( U_1(x) \), neither the optimal policies.

As the results of Theorem 4 indicate, the inverse investment problem (7) essentially reduces to solving the functional equation (9). We study this equation next.
6 A functional equation for inverse marginals

In this section, we analyze the linear functional equation (9), with $I_0$ given and $I_1$ to be found, for positive constants $a, b, c$, given by (10). We provide conditions for the existence and uniqueness of its solutions and, in particular, solutions in the class of inverse marginal functions.

First of all, we note that the solution to (9) is known in literature for $b < 0$ (e.g. Polyanin and Manzhirov (1998)). Unfortunately, in our case $b = \frac{1-a}{q} > 0$ for which we are not aware of any results to our best knowledge.

When $a = 1$, the unique solution is trivially $I_1(y) = I_0(y)$. This is economically intuitive. If $p = q$, then essentially there is no risk premium to exploit. As a result, when $r = 0$ as assumed herein, the pricing kernel becomes a constant, $\rho = 1$, and the optimal wealth reduces to $X^*(x) = x$. In turn, the value function (at $t = 0$) coincides with the terminal utility. So the forward performance remains constant, $U_0(x) = U_1(x)$, and thus their inverse marginals $I_0$ and $I_1$ coincide. Indeed, there is no reason to modify the performance function in a market with no investment opportunities.

Henceforth we assume that $a \neq 1$. We start with an example showing that a general solution of (9) may not be unique, even if we restrict the solutions to inverse marginal functions.

Example 6. Let $I_0(y) = y^\log_a b$, $y > 0$, for constants $a, b > 0$ such that $\log_a b < 0$. It is easy to check that the function $I_1(y) = \delta y^\log_a b$, $y > 0$, with $\delta = \frac{(1+b)}{2b c^{\log_a b}} > 0$, is a solution to (9).

However, this particular solution is not the only solution. Indeed, consider any differentiable anti-periodic function, say $\Theta(z) = -\Theta(z + \ln a)$, for which there exists a constant $M > 0$ such that

$$
\sup_{z \in \mathbb{R}}(|\Theta(z)|, |\Theta'(z)|) < M < -\delta \log_a b
$$

For instance, $\Theta(x) = M \sin(\frac{x}{\log_a \pi})$ is such a function. One can then directly check that the function

$$
\tilde{I}_1(y) = y^\log_a b \left( \delta + \Theta(\ln y) \right); \quad y > 0
$$

is a solution.

As a matter of fact, both solutions $I_1$ and $\tilde{I}_1$ are inverse marginals. This is obvious for $I_1$. As for $\tilde{I}_1$, we have $\lim_{y \rightarrow \infty} \tilde{I}_1(y) = 0$ since $\log_a b < 0$. Moreover, it follows from the inequality $\tilde{I}_1(y) \geq y^\log_a b (\delta - M)$, $y > 0$, that $\lim_{y \rightarrow 0^+} \tilde{I}_1(y) = \infty$. Furthermore,

$$
\tilde{I}_1(y) = y^\log_a b - 1 \log_a b \left( \delta + \Theta(\ln y) + \frac{\Theta'(\ln y)}{\log_a b} \right)
$$

$$
\leq y^\log_a b - 1 \log_a b \left( \delta - \frac{M \log_a b - M}{\log_a b} \right) < 0; \quad y > 0.
$$

Thus, in general, there is no uniqueness even among inverse marginal functions.

---

This is also in accordance with the so-called time-monotone forward processes in the continuous-time setting. For example, in Musiela and Zariphopoulou (2010b), it is shown that this forward performance is given by $U(x, t) = u(x, \int_0^t |\lambda_s|^2 ds)$, with $u(x, t)$ being a deterministic function and the process $\lambda$ is the market price of risk. If $\lambda \equiv 0$, then $U(x, t) = u(x, 0) = U(x, 0)$, for all $t > 0$. 

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12
The above example suggests that we need additional conditions to ensure uniqueness. To identify these conditions, we first note that (9) is a functional equation of the more general form

\[ F(f(y)) = g(y)F(y) + h(y), \]  

(15)

with \( f, g, \) and \( h \) given functions, \( y \in \mathcal{Y} \subseteq \mathbb{R} \) and \( F \) to be found. The equations of this type have been studied in the literature; see Kuczma et al. (1990) and the references therein for a general exposition.

In general, such equations have many solutions. A trivial example is \( F(y + 1) = F(y), y \in \mathbb{R}, \) for which any periodic function with period 1 is a solution. Such non-uniqueness often renders the underlying equation inapplicable for concrete problems, where a single well-defined solution is usually needed. For the general equation (15), conditions for the uniqueness of solutions usually limit the set of solutions by imposing additional assumptions on \( F(y_0) \), where \( y_0 \) is a fixed point for \( f: f(y_0) = y_0 \).

We start with the following auxiliary result in which we provide general uniqueness conditions for equation (9). Afterwards, we will strengthen the results for the family of inverse marginals.

**Lemma 7.** Let \( I_0 \) be given. Then, there exists at most one solution to (9), say \( I_1 \), satisfying \( \lim_{y \to 0^+} y^{- \log_a b} I(y) = 0 \). Similarly, there exists at most one solution satisfying \( \lim_{y \to \infty} y^{- \log_a b} I(y) = 0 \).

**Proof.** See Appendix B.

We note that the function \( \tilde{I}_1 \) in Example 6 satisfies neither conditions in Lemma 7, and thus uniqueness fails.

Next, we state the main result for this section, which provides sufficient conditions for existence and uniqueness of solutions to (9) that are inverse marginal functions.

**Theorem 8.** Let \( I_0 \) in (9) be an inverse marginal, i.e. \( I_0 \in \mathcal{I} \) with \( \mathcal{I} \) defined in (8). Define the functions

\[ \Phi_0(y) = I_0(ac y) - bI_0(c y) \quad \text{and} \quad \Psi_0(y) = y^{- \log_a b} I_0(c y); \ y > 0. \]  

(16)

The following assertions hold:

(i) If \( \Phi_0 \) is strictly increasing and, either \( a > 1 \) and \( \lim_{y \to \infty} \Psi_0(y) = 0 \) or \( a < 1 \) and \( \lim_{y \to 0^+} \Psi_0(y) = 0 \), then a solution of (9) is given by

\[ I_1(y) = \frac{1 + b}{b} \sum_{m=0}^{\infty} (-1)^m b^{-m} I_0(a^m c y); \ y > 0. \]  

(17)
(ii) If $\Phi_0$ is strictly decreasing and, either $a > 1$ and $\lim_{y \to 0^+} \Psi_0(y) = 0$ or $a < 1$ and $\lim_{y \to \infty} \Psi_0(y) = 0$, then a solution of (9) is given by

$$I_1(y) = (1 + b) \sum_{m=0}^{\infty} (-1)^m b^n I_0(a^{-(m+1)} cy); \ y > 0.$$  \hfill (18)

(iii) In parts (i) and (ii), the corresponding $I_1$ satisfies the uniqueness condition(s) of Lemma 7 and, moreover, $I_1 \in I$, i.e., $I_1$ preserves the inverse marginal properties.

(iv) The function $I_1$ in parts (i) and (ii), respectively, is the only positive solution of (9). It is also the only inverse marginal function that solves (9).

Proof. See Appendix C.

Now, we apply the above results to the case when the initial utility is a power function. The following example provides results complementary to the ones in Example 6 where uniqueness is lacking since the conditions of Lemma 7 are not satisfied.

Corollary 9. Let $U_0(x) = (1 - \frac{1}{\theta})^{-1} x^{1-\frac{1}{\theta}}, x > 0$, and assume that $1 \neq \theta > 0$, $\theta \neq -\log a b$, with $a, b, c > 0$ given by (10). Then, the following assertions hold:

(i) The unique inverse marginal function that satisfies the functional equation (9) with initial $I_0(y) = y^{-\theta}$ is given by

$$I_1(y) = \delta y^{-\theta}; \ y > 0,$$

where $\delta = \frac{1+b}{c(a^{-\frac{1}{\theta}}+b)}$.

(ii) The unique utility function $U_1$ that satisfies the inverse investment problem (7) is given by

$$U_1(x) = \delta^{\frac{1}{\theta}} \left( 1 - \frac{1}{\theta} \right)^{-1} x^{1-\frac{1}{\theta}} = \delta^{\frac{1}{\theta}} U_0(x); \ x > 0.$$

(iii) The corresponding optimal allocation is given by

$$\pi^*(x) = \frac{\delta(p/q)^{\frac{1}{\theta}} - 1}{u-1} x; \ x > 0.$$

Therefore, if we start with an initial power utility $U_0$, then the forward utility at $t = 1$ is a multiple of the initial datum, with the constant given by $\delta^{\frac{1}{\theta}}$. Note that $\delta$ incorporate both the preference parameter $\theta$ and also the market parameters $a$, $b$, and $c$ at the beginning of the trading period $t = 0$. Proceeding iteratively, the utilities for all future periods remain power functions. In other words, in the binomial setting, the (predictable) power utility preferences are preserved throughout.
7 Construction of the predictable forward performance process

We are now ready to present the general algorithm for the construction of forward performance processes as well as the associated optimal investment strategies and their wealth processes. We stress that one of the main strengths of our approach is that for every given trading period, say \([t_n, t_{n+1}]\), we did not have to update the model parameters \((u_{n+1}, d_{n+1}, p_{n+1})\) for this period until time \(t_n\) arrives. Thus, we take full advantage of the incoming information up to time \(t_n\). This is in contrast with the classical setting where, as we mentioned earlier, these parameters have to be pre-specified at initial time.

The algorithm is based on repeatedly applying, conditionally on the new information, the following result on the single-period inverse investment problem (7).

**Theorem 10.** For the inverse investment problem (7), assume that the initial inverse marginal \(I_0 = (U_0')^{-1}\) satisfies condition (i) (resp. condition (ii)) in Theorem 8, and define \(I_1\) by (17) (resp. (18)). Then, the unique solution to (7) is given by

\[
U_1(x) = U_0(1) + E_p \left[ \int_{I_1(\rho_1 U_0'(1))}^{x} I_1^{-1}(\xi)d\xi \right]; \quad x > 0,
\]

where \(\rho_1\) is as in (6). Moreover, the optimal wealth \(X_1^*(x)\) and the associated optimal investment allocation \(\pi^*(x)\) are given, respectively, by

\[
X_1^*(x) = I_1(\rho_1 U_0'(x)) = X_{1,u}^*(x)1_{R_1=u} + X_{1,d}^*(x)1_{R_1=d}
\]

and

\[
\pi^*(x) = \frac{X_{1,u}^*(x) - X_{1,d}^*(x)}{u - d},
\]

where

\[
X_{1,u}^*(x) := I_1 \left( \frac{q_1}{p_1} U_0'(x) \right) \quad \text{and} \quad X_{1,d}^*(x) := I_1 \left( \frac{1 - q_1}{1 - p_1} U_0'(x) \right).
\]

**Proof.** The results follow directly from Theorem 8 and Theorem 4. \(\square\)

Given an initial performance function \(U_0\) and initial wealth \(X_0\), the following algorithm provides the predictable forward performance process \(\{U_1, U_2, \ldots\}\) along with the associated optimal portfolio process \(\{\pi_1^*, \pi_2^*, \ldots\}\) and the wealth process \(\{X_1^*, X_2^*, \ldots\}\) in the binomial market model.

- At \(t = 0\) : Assess the market parameters \((u_1, d_1, p_1)\) for the first investment period, \([0, t_1]\). Compute

\[
q_1 = \frac{1 - d_1}{u_1 - d_1}, \quad a_1 = \frac{q_1(1 - p_1)}{p_1(1 - q_1)}, \quad b_1 = \frac{1 - q_1}{q_1}, \quad \text{and} \quad c_1 = \frac{1 - p_1}{1 - q_1},
\]

and

\[
\rho_1^u = \frac{q_1}{p_1} \quad \text{and} \quad \rho_1^d = \frac{1 - q_1}{1 - p_1}.
\]
Using \((a_1, b_1, c_1)\), check the conditions in part (i) (resp. (ii)) of Theorem 8, and obtain the inverse marginal function \(I_1\) from (17) (resp. (18)). Then, apply Theorem 10 to compute

\[
U_1(x) = U_0(1) + p_1 \int_{I_1(\rho_{1}^t U_0'(1))}^{x} I_1^{-1}(\xi) d\xi + (1 - p_1) \int_{I_1(\rho_{1}^t U_0'(1))}^{x} I_1^{-1}(\xi) d\xi; \quad x > 0,
\]

where

\[
\pi_1^* = \frac{X_{1}^{*,u}(X_0) - X_{1}^{*,d}(X_0)}{u - d},
\]

and

\[
X_1^* = X_0 + \pi_1^* (R_3 - 1),
\]

where

\[
X_1^{*,u}(x) = I_1\left(\frac{q_1}{p_1} U_0'(x)\right) \quad \text{and} \quad X_1^{*,d}(x) = I_1\left(\frac{1 - q_1}{1 - p_1} U_0'(x)\right); \quad x > 0.
\]

- At \(t = t_n (n = 1, 2, \cdots)\): We have already obtained \(\{U_1, \cdots, U_n; I_1, \cdots, I_n\}, \{\pi_1^*, \cdots, \pi_n^*\}\) and \(\{X_1^*, \cdots, X_n^*\}\).

Estimate the market parameters \((u_{n+1}, d_{n+1}, p_{n+1})\) for the upcoming investment period \([t_n, t_{n+1})\). Let

\[
q_{n+1} = \frac{1 - d_{n+1}}{u_{n+1} - d_{n+1}}, \quad a_{n+1} = \frac{q_{n+1}(1 - p_{n+1})}{p_{n+1}(1 - q_{n+1})}, \quad b_{n+1} = \frac{1 - q_{n+1}}{q_{n+1}},
\]

\[
c_{n+1} = \frac{1 - p_{n+1}}{1 - q_{n+1}}, \quad \rho_{n+1}^u = \frac{q_{n+1}}{p_{n+1}} \quad \text{and} \quad \rho_{n+1}^d = \frac{1 - q_{n+1}}{1 - p_{n+1}}.
\]

Check the conditions in part (i) (resp. (ii)) in Theorem 8, using \((a_{n+1}, b_{n+1}, c_{n+1})\) (instead of \((a, b, c)\)) and \(I_n\) instead of \(I_0\), and obtain \(I_{n+1}\) from (17) (resp. (18)).

\[\text{(20)}\]

Compute

\[
U_{n+1}(x) = U_n(1) + p_{n+1} \int_{I_{n+1}(\rho_{n+1}^u U_n'(1))}^{x} I_{n+1}^{-1}(\xi) d\xi
\]

\[
+ (1 - p_{n+1}) \int_{I_{n+1}(\rho_{n+1}^d U_n'(1))}^{x} I_{n+1}^{-1}(\xi) d\xi; \quad x > 0,
\]

\[
\pi_{n+1}^* = \frac{X_{n+1}^{*,u}(X_n) - X_{n+1}^{*,d}(X_n)}{R_{n+1}^u - R_{n+1}^d},
\]

and

\[
X_{n+1}^* = X_n^* + \pi_{n+1}^* (R_{n+1} - 1) = X_0 + \sum_{i=1}^{n+1} \pi_{i}^* (R_i - 1),
\]

where

\[
X_{n+1}^{*,u}(x) = I_{n+1}\left(\frac{q_{n+1}}{p_{n+1}} U_n'(x)\right) \quad \text{and} \quad X_{n+1}^{*,d}(x) = I_{n+1}\left(\frac{1 - q_{n+1}}{1 - p_{n+1}} U_n'(x)\right); \quad x > 0.
\]

If both conditions in part (i) and (ii) do not hold, then the functional equation (9) may not have a solution, or the solution may not be unique. For the case of initial power utility \(U_0(x) = \frac{1}{1 - \theta} x^\theta, \theta > 0\), Example 6 and Corollary 9 show that both condition fail at \(t_n\) if and only if \(\theta = -\log_b a > 0\), in which case the solution exists but is not unique. This case is pathological, but to solve it remains a technically interesting question.
In summary, starting with an initial datum \( U_0 \), we have constructed for (the end of) each trading period, say \((t_n, t_{n+1}]\), \( n = 1, 2, ..., \) a performance criterion \( U_{n+1} \) at \( t_{n+1} \) that is indeed \( \mathcal{F}_{n} \)-measurable. This measurability is inherited by the same measurability of the inverse marginal \( I_{n+1} \) that enters in the lower part of the integration in (20). Moreover, as expected, the optimal wealth \( X_{n+1}^* \) is \( \mathcal{F}_{n+1} \)-measurable, given that the pricing kernel \( \rho_{n+1} \) is \( \mathcal{F}_{n+1} \)-measurable. The optimal portfolio \( \pi_{n+1}^* \) is \( \mathcal{F}_{n} \)-measurable, chosen at the beginning of the period \( [t_n, t_{n+1}) \).

8 Conclusions

We have introduced a discrete time analogue of the continuous time forward performance processes, focusing on the predictability of such criteria. Specifically, at the beginning of each evaluation period, the investor assesses the market parameters only for this period (during which trading may take place once or many times, in both discrete or continuous fashion). Then, she solves an inverse single-period inverse investment model which yields the utility at the end of the period, given the one at the beginning. The martingality and supermartingality requirements of the forward performance process ensure that this construction, “period-by-period forward in time” and adapted to the new market information, yields time-consistent policies.

We have implemented this new approach in a binomial model with random, dynamically updated parameters, including both the probabilities and the levels of the stock returns. We have then discussed in detail how the construction of predictable forward performance processes essentially reduces to a single-period inverse investment problem. We have, in turn, shown that the latter is equivalent to solving a functional equation involving the inverse marginal functions at the beginning and the end of the trading period, and have established conditions for the existence and uniqueness of solutions in the class of inverse marginal functions.

We have finally provided an explicit algorithm that yields the forward performance process as well as their optimal portfolio and the associated optimal wealth processes.

There are a number of possible future research directions. Firstly, one may depart from the binomial model to study general discrete-time models, while allowing for trading to be discrete or continuous. Such models are inherently incomplete and additional difficulties are expected to arise with regards to the derivation of the functional equation for the inverse marginals as well as the existence and uniqueness of its solutions among suitable classes of functions.

A second direction is to enrich the predictable framework by incorporating model ambiguity. This will allow for the specification of all possible market models only one evaluation period ahead, thus offering substantial flexibility to narrow down the most realistic models period-by-period as the market evolves.

From the theoretical point of view, an interesting question is to investigate whether discrete predictable forward performance processes converge to their continuous-time counterparts. While this is naturally and intuitively expected, conditions on the appropriate convergence scaling need to be imposed, which might be quite challenging due to the ill-posedness of the problem. Such results may also shed light to deeper questions on the construction of continuous-time forward performance criteria related to the appropriate choice
of their volatility, finite-dimensional approximations, Markovian or path-dependent cases, among others.

A Proof of Theorem 4

We start with the following auxiliary result, showing that the expected utility problem (7) is equivalent to

\[ U_0(I_0(y)) = E_P(U_1(I_1(\rho_1 y))); \quad y > 0. \]  

(21)

**Lemma 11.** Suppose that \( U_0, U_1 \in \mathcal{U} \) and let \( I_0 \) and \( I_1 \) be respectively their inverse marginals. Then, (7) holds if and only if (21) holds.

**Proof.** We first show that (7) implies (21). Indeed, standard results in expected utility maximization yield that (7) implies

\[ U_0(x) = E_P\left[U_1\left(I_1(\rho_1 U_0'(x))\right)\right]; \quad x > 0, \]

and (21) is then obtained by the change of variable \( y = U_0'(x) \).

Next, we show that (21) yields (7). Define the value function \( \tilde{U} \) by

\[ \tilde{U}(x) := \sup_{\mathcal{A}(x)} E_P[U_1(X)]; \quad x > 0. \]

We claim that \( \tilde{U} \equiv U_0 \). Let \( \tilde{I} \) be the inverse marginal of \( \tilde{U} \). By (i), one must then have

\[ \tilde{U}(\tilde{I}(y)) = E_P\left[U_1(I_1(\rho_1 y))\right]; \quad y > 0, \]

and it follows that \( \tilde{U}(\tilde{I}(y)) = U_0(I_0(y)) \), for \( y > 0 \).

Differentiating with respect to \( y \) yields \( \tilde{V} \equiv I_0 \). Therefore \( \tilde{I}(y) = I_0(y) + C, \ y > 0 \), for some constant \( C \). Taking the limit as \( y \to \infty \) and using the Inada condition \( \tilde{I}(\infty) = I_0(\infty) = 0 \), we deduce that \( C = 0 \). Therefore, we obtain \( \tilde{I} \equiv I_0 \), which implies \( U_1'(x) = U_0'(x) \), for all \( x > 0 \). Finally, we obtain

\[ \tilde{U}(x) = E_P\left[U_1(I_1(\rho U_0'(x)))\right] = E_P\left[U_1(I_1(\rho U_0'(x)))\right] = U_0(x); \quad x > 0. \]  

\[ \square \]

**Proof of Theorem 4.** (i): From (14) it follows that

\[ U_1(x) := U_0(1) + p \int_{x_u(1)}^{x} I_1^{-1}(\xi)d\xi + (1 - p) \int_{x_d(1)}^{x} I_1^{-1}(\xi)d\xi; \quad x > 0, \]

where \( x_u(\cdot) \) and \( x_d(\cdot) \) are given by

\[ x_i(c) = I_1(\rho^i U_0'(c)); \quad c > 0, \ i = u, d. \]  

(22)

Thus,

\[ U_1'(x) = p I_1^{-1}(x) + (1 - p) I_1^{-1}(x) = I_1^{-1}(x); \quad x > 0. \]

It then follows that \( I_1 \) is the inverse marginal of \( U_1 \) and that \( U_1 \) is a utility function.
(ii): Define the function $F$ by

$$F(x, c) := U_0(c) + p \int_{x_u(c)}^{x} I_1^{-1}(\xi) d\xi + (1-p) \int_{x_d(c)}^{x} I_1^{-1}(\xi) d\xi; \quad (x, c) \in \mathbb{R}^+ \times \mathbb{R}^+, \quad (23)$$

with $x_u(c)$ and $x_d(c)$ as in (22). We claim that

$$\frac{\partial F}{\partial c}(x, c) = 0; \quad x, c > 0.$$

Indeed, differentiating (23) with respect to $c$ and then using that $I_1^{-1}(x_i(c)) = \rho^i U'_0(c)$, for $c > 0$, we have

$$\frac{\partial F}{\partial c}(x, c) = U'_0(c) - px'_a(c) G(x_u(c)) - (1-p)x'_d(c) G(x_d(c))$$

$$= U'_0(c) - px'_a(c) \rho^a U'_0(c) - (1-p)x'_d(c) \rho^d U'_0(c)$$

$$= U'_0(c) \left( 1 - \rho^a x'_a(c) - (1-p) \rho^d x'_d(c) \right) = 0.$$

To obtain the last equation, note that equation (9) is equivalent to

$$I_0(y) = \rho^a I_1(y \rho_a) + (1-p) \rho^d I_1(y \rho_d); \quad y > 0.$$

Therefore, substituting $y = U_0(c)$ and differentiating with respect to $c$ yield

$$1 = \frac{d}{dc} \left( \frac{I_0(U_0(c))}{U_0(c)} \right) = \frac{d}{dc} \left( \frac{\rho^a I_1 \left( \rho_a U_0(c) \right) + (1-p) \rho^d I_1 \left( \rho_d U_0(c) \right)}{U_0(c)} \right)$$

$$= \rho^a x'_a(c) + (1-p) \rho^d x'_d(c).$$

Note that, by definition, $U_1(x) = F(x, 1)$. Since we have showed that $\frac{\partial F}{\partial c} \equiv 0$, we must have $U_1(x) = F(x, c)$, for all $x > 0$ and $c > 0$. In other words, for all $x, c \in \mathbb{R}^+$, $U_1$ satisfies

$$U_1(x) = U_0(c) + p \int_{x_u(c)}^{x} I_1^{-1}(\xi) d\xi + (1-p) \int_{x_d(c)}^{x} I_1^{-1}(\xi) d\xi.$$

On the other hand, as it was shown in (i), $U'_1 \equiv I_1^{-1}$. Therefore, for all $x > 0$ and $c > 0$,

$$U_1(x) = U_0(c) + p \left( U_1(x) - U_1(x_u(c)) \right) + (1-p) \left( U_1(x) - U_1(x_d(c)) \right),$$

which, in turn, yields that

$$U_0(c) = pU_1(x_u(c)) + (1-p)U_1(x_d(c)) = E_F \left[ U_1(I_1(\rho_1 U_0(c))) \right]; \quad c > 0.$$

This is equivalent to (21). Hence, (ii) follows from Lemma 11.

(iii): This part follows easily from existing results in the classical expected utility problems, if we view (7) as a terminal expected utility problem with $U_1$ now given and $U_0$ being its value function.
B  Proof of Lemma 7

Let \( F_1 \) and \( F_2 \) be two solutions of (9) that both satisfy either conditions given in the lemma. We show that their difference \( w := F_1 - F_2 \equiv 0 \).

The function \( w \) satisfies the homogenous equation \( w(ay) = -bw(y), \ y > 0 \). Therefore, for \( k = 1, 2, \ldots \),

\[
w(y) = \frac{w(ay)}{-b} = \frac{w(a^2y)}{(-b)^2} = \cdots = \frac{w(a^ky)}{(-b)^k},
\]

and

\[
w(y) = -bw \left( \frac{y}{a} \right) = (-b)^2w \left( \frac{y}{a^2} \right) = \cdots = (-b)^kw \left( \frac{y}{a^k} \right).
\]

It then follows that for \( k = \pm 1, \pm 2, \ldots \) and \( y > 0 \),

\[
|w(y)| = b^k |w\left( \frac{y}{a^k} \right)| = y^{\log_a b} \left( \frac{y}{a^k} \right)^{-\log_a b} |w\left( \frac{y}{a} \right)| \\
\leq y^{\log_a b} \left( \frac{y}{a^k} \right)^{-\log_a b} \left( |F_1\left( \frac{y}{a^k} \right)| + |F_2\left( \frac{y}{a^k} \right)| \right).
\]

The right side vanishes as either \( k \to \infty \) or \( k \to -\infty \), and we conclude.

C  Proof of Theorem 8

We only show part (i) and the corresponding statements in parts (iii) and (iv), since (ii) follows from similar arguments.

(i) Direct substitution shows that if the infinite series in (17) converges, then \( I_1 \) satisfies equation (9). Thus, to show (i), it only remains to establish that the series converges. Note that (17) can be written, for \( y > 0 \), as

\[
I_1(y) = \frac{b}{1 + b} y^{\log_a b} \sum_{m=0}^{\infty} (-1)^m \Psi_0(a^m y),
\]

which, by the Leibniz test for alternating series, converges if \( \lim_{m \to \infty} \Psi_0(a^m y) = 0 \) monotonically. The fact that \( \lim_{m \to \infty} \Psi_0(a^m y) = 0 \) follows directly from either of the conditions in (i) on \( a \) and \( \Psi_0 \). To show that the convergence is monotonic, note that (16) yields

\[
\Psi_0(a^{m+1} y) - \Psi_0(a^m y) = b^{-m-1} y^{-\log_a b} \Phi_0(a^m y); \quad y > 0, \ m = 0, 1, \ldots
\]

On the other hand, since \( \Phi_0 \) is increasing and \( \lim_{y \to \infty} \Phi_0(y) = \lim_{y \to \infty} (I_0(a \, c \, y) - b \, I_0(c \, y)) = 0 \), by Inada’s condition, we must have \( \Phi_0(y) < 0 \), for \( y > 0 \). Thus, by (25), we deduce that \( \Psi_0(a^m y) > \Psi_0(a^{m+1} y) \) and \( \lim_{m \to \infty} \Psi_0(a^m y) = 0 \) monotonically.

(iii) First, we prove that \( I_1 \) is strictly decreasing. Indeed, (24) and (25) yield

\[
I_1(y) = \frac{b}{1 + b} y^{\log_a b} \sum_{m=0}^{\infty} \left( \Psi_0(a^{2m} y) - \Psi_0(a^{2m+1} y) \right) = - \frac{1}{1 + b} \sum_{m=0}^{\infty} b^{-2m} \Phi_0(a^{2m} y).
\]

It then follows that, for \( y < y' \),

\[
I_1(y') - I_1(y) = \frac{1}{1 + b} \sum_{m=0}^{\infty} b^{-2m} \left( \Phi_0(a^{2m} y) - \Phi_0(a^{2m} y') \right) < 0,
\]

20
where the inequality holds because $\Phi_0$ is strictly increasing.

Using equation (9), that $a, b, c > 0$, that $\lim_{y \to \infty} I_0(y) = 0$, and the monotonicity of $I_1$, we deduce that $\lim_{y \to \infty} I_1(y) = 0$, and hence, $I_1(y) > 0$, for $y > 0$. Similarly, the fact that $\lim_{y \to 0^+} I_0(y) = \infty$ yields that $\lim_{y \to 0^+} I_1(y) = \infty$. Thus, we have shown that $I_1 \in I$.

Finally, the conditions in Lemma 7 follow from $\Psi_0(y) \to 0$, as either $y \to 0^+$ or $y \to \infty$, and from the inequalities

$$0 < y^{\log_a b} I_1(y) = \frac{I_1(y)}{I_0(c y)} \Psi_0(y) < \frac{b + 1}{b} \Psi_0(y); \quad y > 0,$$

where we used (9) and that $I_1(y) > 0$ to obtain

$$\frac{I_1(y)}{I_0(c y)} = \frac{(1 + b)I_1(y)}{I_1(a y) + b I_1(y)} < \frac{1 + b}{b}.$$ 

(iv) Repeating the last part of the arguments in part (iii) for any solution $\tilde{I} > 0$ yields that $\tilde{I}$ satisfies the same uniqueness condition for (9) as $I_1$. The result then follows directly from Lemma 7.

**D Proof of Corollary 9**

Assertion (ii) follows from (i) and Theorem 4. Also, one can easily check that $I_1$ given by (19) is thus an inverse marginal satisfying equation (9).

It only remains to show the uniqueness of solutions that are inverse marginals. To this end, it suffices to check that the conditions of Theorem 8 holds for all possible values of the parameters. Setting $G(y) = y^{-\theta}$, $y > 0$, in (16) yields

$$\Phi_0(y) = (a^{-\theta} - b) e^{-\theta} y^{-\theta} \quad \text{and} \quad \Psi_0(y) = y^{-(\theta + \log_a b)}.$$ 

Since $\theta \neq -\log_a b$ and $a \neq 1$, we have the following dichotomy:

a) Either $\theta < -\log_a b$ and $a < 1$ or $\theta > -\log_a b$ and $a > 1$. Then, one can show that conditions (i) of Theorem 8 hold.

b) Either $\theta < -\log_a b$ and $a > 1$ or $\theta > -\log_a b$ and $a < 1$. Then, one can show that conditions (ii) of Theorem 8 hold.

**References**


