

# Contents

## Part I Principles

<b>1</b>	<b>Interest Rates and Financial Derivatives</b> .....	3
1.1	Interest Rates and Deterministic Cash Flows .....	3
1.1.1	Deterministic Cash Flows .....	4
1.1.2	Arbitrage-Free Cash Flows .....	5
1.2	Derivatives and No-Arbitrage Pricing .....	14
1.2.1	The Lognormal Model .....	20
1.2.2	Implied Forward Probabilities .....	23
1.3	Notes and Comments .....	28
1.4	Exercises .....	29
<b>2</b>	<b>Convex Optimization</b> .....	33
2.1	Basic Convex Optimization .....	33
2.2	More General Convex Optimization .....	36
2.3	Notes and Comments .....	38
<b>3</b>	<b>Quadratic Hedging Principles</b> .....	39
3.1	Conditional Expectations and Linear Regression .....	40
3.1.1	Examples .....	43
3.1.2	Proofs of Propositions .....	44
3.2	Hedging with Futures .....	46
3.3	Hedging of Insurance Liabilities .....	52
3.4	Hedging of a Digital Option with Call Options .....	59
3.5	Delta Hedging .....	62
3.5.1	Dynamic Hedging of a Call Option .....	66
3.6	Immunization of Cash Flows .....	68
3.6.1	Immunization and Principal Component Analysis .....	74
3.7	Notes and Comments .....	80
3.8	Exercises .....	80

<b>4 Quadratic Investment Principles</b> .....	85
4.1 Quadratic Investments Without a Risk-Free Asset .....	87
4.2 Quadratic Investments with a Risk-Free Asset .....	92
4.2.1 The Trade-Off Problem.....	92
4.2.2 Maximization of Expectation and Minimization of Variance .....	96
4.2.3 Evaluating the Methods on Simulated Data .....	99
4.2.4 Different Borrowing and Lending Rates.....	104
4.3 Investments in the Presence of Liabilities.....	106
4.4 Large Portfolios .....	112
4.5 Problems with Mean–Variance Analysis.....	117
4.6 Notes and Comments .....	122
4.7 Exercises.....	122
<b>5 Utility-Based Investment Principles</b> .....	127
5.1 Maximization of Expected Utility .....	128
5.2 A Horse Race Example .....	138
5.3 The Optimal Derivative Position .....	144
5.3.1 Examples with Lognormal Distributions .....	147
5.3.2 Investments in the Presence of Liabilities .....	150
5.4 Notes and Comments .....	154
5.5 Exercises.....	155
<b>6 Risk Measurement Principles</b> .....	159
6.1 Risk Measurement .....	159
6.2 Value-at-Risk .....	165
6.3 Expected Shortfall .....	178
6.4 Risk Measures Based on Utility Functions .....	187
6.5 Spectral Risk Measures .....	188
6.6 Notes and Comments .....	191
6.7 Exercises.....	192

## **Part II Methods**

<b>7 Empirical Methods</b> .....	197
7.1 Sample Preparation .....	198
7.2 Empirical Distributions .....	200
7.3 Empirical Quantiles .....	204
7.4 Empirical VaR and ES .....	210
7.5 Confidence Intervals .....	214
7.5.1 Exact Confidence Intervals for Quantiles.....	214
7.5.2 Confidence Intervals Using the Nonparametric Bootstrap ....	216
7.6 Bootstrapping in Nonlife Insurance.....	220
7.6.1 Claims Reserve Prediction Via the Chain Ladder.....	220
7.7 Notes and Comments .....	225
7.8 Exercises.....	226

<b>8</b>	<b>Parametric Models and Their Tails</b> .....	231
8.1	Model Selection and Parameter Estimation .....	232
8.1.1	Examples of Parametric Distributions .....	233
8.1.2	Quantile–Quantile Plots .....	236
8.1.3	Maximum-Likelihood Estimation .....	237
8.1.4	Least-Squares Estimation .....	243
8.1.5	Parametric Bootstrap .....	246
8.1.6	Constructing Parametric Families with q–q Plots .....	248
8.2	Extreme Values and Tail Probabilities .....	253
8.2.1	Heavy Tails and Diversification .....	254
8.2.2	Peaks Over Threshold Method .....	265
8.3	Notes and Comments .....	269
8.4	Exercises .....	270
<b>9</b>	<b>Multivariate Models</b> .....	273
9.1	Spherical Distributions .....	274
9.2	Elliptical Distributions .....	277
9.2.1	Goodness of Fit of an Elliptical Model .....	279
9.2.2	Asymptotic Dependence and Rank Correlation .....	282
9.2.3	Linearization and Elliptical Distributions .....	285
9.3	Applications of Elliptical Distributions in Risk Management .....	291
9.3.1	Risk Aggregation with Elliptical Distributions .....	291
9.3.2	Solvency of an Insurance Company .....	293
9.3.3	Hedging of a Call Option When the Volatility Is Stochastic..	295
9.3.4	Betting on Changes in Volatility .....	298
9.3.5	Portfolio Optimization with Elliptical Distributions .....	299
9.4	Copulas .....	301
9.4.1	Misconceptions of Correlation and Dependence .....	311
9.5	Models for Large Portfolios .....	320
9.5.1	Beta Mixture Model .....	322
9.6	Notes and Comments .....	325
9.7	Exercises .....	325
	<b>References</b> .....	331
	<b>Index</b> .....	333