

Contents

Preface *xiii*

1	Introduction	<i>1</i>
1.1	Statistical Finance	<i>2</i>
1.2	Risk Management	<i>3</i>
1.3	Portfolio Management	<i>5</i>
1.4	Pricing of Securities	<i>6</i>

Part I **Statistical Finance** *11*

2	Financial Instruments	<i>13</i>
2.1	Stocks	<i>13</i>
2.1.1	Stock Indexes	<i>14</i>
2.1.2	Stock Prices and Returns	<i>15</i>
2.2	Fixed Income Instruments	<i>19</i>
2.2.1	Bonds	<i>19</i>
2.2.2	Interest Rates	<i>20</i>
2.2.3	Bond Prices and Returns	<i>22</i>
2.3	Derivatives	<i>23</i>
2.3.1	Forwards and Futures	<i>23</i>
2.3.2	Options	<i>24</i>
2.4	Data Sets	<i>27</i>
2.4.1	Daily S&P 500 Data	<i>27</i>
2.4.2	Daily S&P 500 and Nasdaq-100 Data	<i>28</i>
2.4.3	Monthly S&P 500, Bond, and Bill Data	<i>28</i>
2.4.4	Daily US Treasury 10 Year Bond Data	<i>29</i>
2.4.5	Daily S&P 500 Components Data	<i>30</i>

3	Univariate Data Analysis	33
3.1	Univariate Statistics	34
3.1.1	The Center of a Distribution	34
3.1.2	The Variance and Moments	37
3.1.3	The Quantiles and the Expected Shortfalls	40
3.2	Univariate Graphical Tools	42
3.2.1	Empirical Distribution Function Based Tools	43
3.2.2	Density Estimation Based Tools	53
3.3	Univariate Parametric Models	55
3.3.1	The Normal and Log-normal Models	55
3.3.2	The Student Distributions	59
3.4	Tail Modeling	61
3.4.1	Modeling and Estimating Excess Distributions	62
3.4.2	Parametric Families for Excess Distributions	65
3.4.3	Fitting the Models to Return Data	74
3.5	Asymptotic Distributions	83
3.5.1	The Central Limit Theorems	84
3.5.2	The Limit Theorems for Maxima	88
3.6	Univariate Stylized Facts	91
4	Multivariate Data Analysis	95
4.1	Measures of Dependence	95
4.1.1	Correlation Coefficients	97
4.1.2	Coefficients of Tail Dependence	101
4.2	Multivariate Graphical Tools	103
4.2.1	Scatter Plots	103
4.2.2	Correlation Matrix: Multidimensional Scaling	104
4.3	Multivariate Parametric Models	107
4.3.1	Multivariate Gaussian Distributions	107
4.3.2	Multivariate Student Distributions	107
4.3.3	Normal Variance Mixture Distributions	108
4.3.4	Elliptical Distributions	110
4.4	Copulas	111
4.4.1	Standard Copulas	111
4.4.2	Nonstandard Copulas	112
4.4.3	Sampling from a Copula	113
4.4.4	Examples of Copulas	116
5	Time Series Analysis	121
5.1	Stationarity and Autocorrelation	122
5.1.1	Strict Stationarity	122
5.1.2	Covariance Stationarity and Autocorrelation	126
5.2	Model Free Estimation	128

5.2.1	Descriptive Statistics for Time Series	129
5.2.2	Markov Models	129
5.2.3	Time Varying Parameter	130
5.3	Univariate Time Series Models	135
5.3.1	Prediction and Conditional Expectation	135
5.3.2	ARMA Processes	136
5.3.3	Conditional Heteroskedasticity Models	143
5.3.4	Continuous Time Processes	154
5.4	Multivariate Time Series Models	157
5.4.1	MGARCH Models	157
5.4.2	Covariance in MGARCH Models	159
5.5	Time Series Stylized Facts	160

6 Prediction 163

6.1	Methods of Prediction	164
6.1.1	Moving Average Predictors	164
6.1.2	State Space Predictors	166
6.2	Forecast Evaluation	170
6.2.1	The Sum of Squared Prediction Errors	170
6.2.2	Testing the Prediction Accuracy	172
6.3	Predictive Variables	175
6.3.1	Risk Indicators	175
6.3.2	Interest Rate Variables	177
6.3.3	Stock Market Indicators	178
6.3.4	Sentiment Indicators	180
6.3.5	Technical Indicators	180
6.4	Asset Return Prediction	182
6.4.1	Prediction of S&P 500 Returns	184
6.4.2	Prediction of 10-Year Bond Returns	187

Part II Risk Management 193

7	Volatility Prediction	195
7.1	Applications of Volatility Prediction	197
7.1.1	Variance and Volatility Trading	197
7.1.2	Covariance Trading	197
7.1.3	Quantile Estimation	198
7.1.4	Portfolio Selection	199
7.1.5	Option Pricing	199
7.2	Performance Measures for Volatility Predictors	199
7.3	Conditional Heteroskedasticity Models	200
7.3.1	GARCH Predictor	200

7.3.2	ARCH Predictor	203
7.4	Moving Average Methods	205
7.4.1	Sequential Sample Variance	205
7.4.2	Exponentially Weighted Moving Average	207
7.5	State Space Predictors	211
7.5.1	Linear Regression Predictor	212
7.5.2	Kernel Regression Predictor	214
8	Quantiles and Value-at-Risk	219
8.1	Definitions of Quantiles	220
8.2	Applications of Quantiles	223
8.2.1	Reserve Capital	223
8.2.2	Margin Requirements	225
8.2.3	Quantiles as a Risk Measure	226
8.3	Performance Measures for Quantile Estimators	227
8.3.1	Measuring the Probability of Exceedances	228
8.3.2	A Loss Function for Quantile Estimation	231
8.4	Nonparametric Estimators of Quantiles	233
8.4.1	Empirical Quantiles	234
8.4.2	Conditional Empirical Quantiles	238
8.5	Volatility Based Quantile Estimation	240
8.5.1	Location–Scale Model	240
8.5.2	Conditional Location–Scale Model	245
8.6	Excess Distributions in Quantile Estimation	258
8.6.1	The Excess Distributions	259
8.6.2	Unconditional Quantile Estimation	261
8.6.3	Conditional Quantile Estimators	269
8.7	Extreme Value Theory in Quantile Estimation	288
8.7.1	The Block Maxima Method	288
8.7.2	Threshold Exceedances	289
8.8	Expected Shortfall	292
8.8.1	Performance of Estimators of the Expected Shortfall	292
8.8.2	Estimation of the Expected Shortfall	293
	Part III Portfolio Management	297
9	Some Basic Concepts of Portfolio Theory	299
9.1	Portfolios and Their Returns	300
9.1.1	Trading Strategies	300
9.1.2	The Wealth and Return in the One- Period Model	301
9.1.3	The Wealth Process in the Multiperiod Model	304
9.1.4	Examples of Portfolios	306

9.2	Comparison of Return and Wealth Distributions	312
9.2.1	Mean–Variance Preferences	313
9.2.2	Expected Utility	316
9.2.3	Stochastic Dominance	325
9.3	Multiperiod Portfolio Selection	326
9.3.1	One-Period Optimization	328
9.3.2	The Multiperiod Optimization	329
10	Performance Measurement	337
10.1	The Sharpe Ratio	338
10.1.1	Definition of the Sharpe Ratio	338
10.1.2	Confidence Intervals for the Sharpe Ratio	340
10.1.3	Testing the Sharpe Ratio	343
10.1.4	Other Measures of Risk-Adjusted Return	345
10.2	Certainty Equivalent	346
10.3	Drawdown	347
10.4	Alpha and Conditional Alpha	348
10.4.1	Alpha	349
10.4.2	Conditional Alpha	355
10.5	Graphical Tools of Performance Measurement	356
10.5.1	Using Wealth in Evaluation	356
10.5.2	Using the Sharpe Ratio in Evaluation	359
10.5.3	Using the Certainty Equivalent in Evaluation	364
11	Markowitz Portfolios	367
11.1	Variance Penalized Expected Return	369
11.1.1	Variance Penalization with the Risk-Free Rate	369
11.1.2	Variance Penalization without the Risk-Free Rate	371
11.2	Minimizing Variance under a Sufficient Expected Return	372
11.2.1	Minimizing Variance with the Risk-Free Rate	372
11.2.2	Minimizing Variance without the Risk-Free Rate	374
11.3	Markowitz Bullets	375
11.4	Further Topics in Markowitz Portfolio Selection	380
11.4.1	Estimation	380
11.4.2	Penalizing Techniques	381
11.4.3	Principal Components Analysis	382
11.5	Examples of Markowitz Portfolio Selection	383
12	Dynamic Portfolio Selection	385
12.1	Prediction in Dynamic Portfolio Selection	387
12.1.1	Expected Returns in Dynamic Portfolio Selection	387
12.1.2	Markowitz Criterion in Dynamic Portfolio Selection	390
12.1.3	Expected Utility in Dynamic Portfolio Selection	391

- 12.2 Backtesting Trading Strategies 393
- 12.3 One Risky Asset 394
 - 12.3.1 Using Expected Returns with One Risky Asset 394
 - 12.3.2 Markowitz Portfolios with One Risky Asset 401
- 12.4 Two Risky Assets 405
 - 12.4.1 Using Expected Returns with Two Risky Assets 405
 - 12.4.2 Markowitz Portfolios with Two Risky Assets 409

Part IV Pricing of Securities 419

- 13 Principles of Asset Pricing 421
 - 13.1 Introduction to Asset Pricing 422
 - 13.1.1 Absolute Pricing 423
 - 13.1.2 Relative Pricing Using Arbitrage 424
 - 13.1.3 Relative Pricing Using Statistical Arbitrage 428
 - 13.2 Fundamental Theorems of Asset Pricing 430
 - 13.2.1 Discrete Time Markets 431
 - 13.2.2 Wealth and Value Processes 432
 - 13.2.3 Arbitrage and Martingale Measures 436
 - 13.2.4 European Contingent Claims 448
 - 13.2.5 Completeness 451
 - 13.2.6 American Contingent Claims 454
 - 13.3 Evaluation of Pricing and Hedging Methods 456
 - 13.3.1 The Wealth of the Seller 456
 - 13.3.2 The Wealth of the Buyer 458
- 14 Pricing by Arbitrage 459
 - 14.1 Futures and the Put–Call Parity 460
 - 14.1.1 Futures 460
 - 14.1.2 The Put–Call Parity 464
 - 14.1.3 American Call Options 465
 - 14.2 Pricing in Binary Models 466
 - 14.2.1 The One-Period Binary Model 467
 - 14.2.2 The Multiperiod Binary Model 470
 - 14.2.3 Asymptotics of the Multiperiod Binary Model 475
 - 14.2.4 American Put Options 484
 - 14.3 Black–Scholes Pricing 485
 - 14.3.1 Call and Put Prices 485
 - 14.3.2 Implied Volatilities 495
 - 14.3.3 Derivations of the Black–Scholes Prices 498
 - 14.3.4 Examples of Pricing Using the Black–Scholes Model 501
 - 14.4 Black–Scholes Hedging 505

- 14.4.1 Hedging Errors: Nonsequential Volatility Estimation 506
- 14.4.2 Hedging Frequency 508
- 14.4.3 Hedging and Strike Price 511
- 14.4.4 Hedging and Expected Return 512
- 14.4.5 Hedging and Volatility 514
- 14.5 Black–Scholes Hedging and Volatility Estimation 515
- 14.5.1 Hedging Errors: Sequential Volatility Estimation 515
- 14.5.2 Distribution of Hedging Errors 517

- 15 Pricing in Incomplete Models 521**
- 15.1 Quadratic Hedging and Pricing 522
- 15.2 Utility Maximization 523
- 15.2.1 The Exponential Utility 524
- 15.2.2 Other Utility Functions 525
- 15.2.3 Relative Entropy 526
- 15.2.4 Examples of Esscher Prices 527
- 15.2.5 Marginal Rate of Substitution 529
- 15.3 Absolutely Continuous Changes of Measures 530
- 15.3.1 Conditionally Gaussian Returns 530
- 15.3.2 Conditionally Gaussian Logarithmic Returns 532
- 15.4 GARCH Market Models 534
- 15.4.1 Heston–Nandi Method 535
- 15.4.2 The Monte Carlo Method 539
- 15.4.3 Comparison of Risk-Neutral Densities 541
- 15.5 Nonparametric Pricing Using Historical Simulation 545
- 15.5.1 Prices 545
- 15.5.2 Hedging Coefficients 548
- 15.6 Estimation of the Risk-Neutral Density 551
- 15.6.1 Deducing the Risk-Neutral Density from Market Prices 552
- 15.6.2 Examples of Estimation of the Risk-Neutral Density 552
- 15.7 Quantile Hedging 554

- 16 Quadratic and Local Quadratic Hedging 557**
- 16.1 Quadratic Hedging 558
- 16.1.1 Definitions and Assumptions 559
- 16.1.2 The One Period Model 562
- 16.1.3 The Two Period Model 569
- 16.1.4 The Multiperiod Model 575
- 16.2 Local Quadratic Hedging 583
- 16.2.1 The Two Period Model 583
- 16.2.2 The Multiperiod Model 587
- 16.2.3 Local Quadratic Hedging without Self-Financing 593
- 16.3 Implementations of Local Quadratic Hedging 595

16.3.1	Historical Simulation	596
16.3.2	Local Quadratic Hedging Under Independence	599
16.3.3	Local Quadratic Hedging under Dependence	604
16.3.4	Evaluation of Quadratic Hedging	610
17	Option Strategies	615
17.1	Option Strategies	616
17.1.1	Calls, Puts, and Vertical Spreads	616
17.1.2	Strangles, Straddles, Butterflies, and Condors	619
17.1.3	Calendar Spreads	621
17.1.4	Combining Options with Stocks and Bonds	623
17.2	Profitability of Option Strategies	625
17.2.1	Return Functions of Option Strategies	626
17.2.2	Return Distributions of Option Strategies	634
17.2.3	Performance Measurement of Option Strategies	644
18	Interest Rate Derivatives	649
18.1	Basic Concepts of Interest Rate Derivatives	650
18.1.1	Interest Rates and a Bank Account	651
18.1.2	Zero-Coupon Bonds	653
18.1.3	Coupon-Bearing Bonds	656
18.2	Interest Rate Forwards	659
18.2.1	Forward Zero-Coupon Bonds	659
18.2.2	Forward Rate Agreements	661
18.2.3	Swaps	663
18.2.4	Related Fixed Income Instruments	665
18.3	Interest Rate Options	666
18.3.1	Caplets and Floorlets	666
18.3.2	Caps and Floors	668
18.3.3	Swaptions	668
18.4	Modeling Interest Rate Markets	669
18.4.1	HJM Model	670
18.4.2	Short-Rate Models	671
	References	673
	Index	681