Contents

Preface ix
Acknowledgements xi

1 Interest rates and asset returns **1**
Introduction
The economic theory of interest
The time value of money
Spot rates, forward rates and quality spreads
Practical applications of interest rates in financial markets
Returns from holding securities
The nature of the term structure of interest rates
Mortgages and annuities
Exercises
References

2 Presentation of data and descriptive statistics **41**
Introduction
Types of data
Presentation of data
Descriptive statistics
Measures of association
Index numbers
Exercises
Further reading
Appendix

3 Calculus applied to finance **85**
Introduction
Differential calculus
Applications of differential calculus
Maxima and minima
Differentiating functions of more than one variable
Integral calculus or integration
Exercises
References and further reading

4 Probability distributions: applications to asset returns **121**
Introduction to probability
Basic rules of probability
Discrete and continuous random variables
The algebra of discrete random variables
Expected value and variance of a discrete random variable
Application of discrete random variables: calculating the returns and standard deviation of a portfolio
Exercises
Appendix

5 Statistical inference: confidence intervals and hypothesis testing **161**
Introduction
Sampling theory
Estimation and confidence intervals
Hypothesis testing
Exercises
Further reading
Appendix

6 Regression analysis **187**
Introduction
Simple linear regression
Ordinary least-squares regression
Using regression for prediction
Multiple regression
Breakdown of the OLS assumptions
Dummy variables
Non-linear regression
Data transformations
Application of regression analysis to hedging
Exercises
References and further reading
Appendices

7 Time-series analysis **227**
Introduction
First some basics
Univariate stochastic models of time-series processes
Tools for analysing time series
Cointegration
Generalized autoregressive conditional heteroscedasticity (GARCH)
Exercises
References
Appendices

8 Numerical methods **271**
Introduction
Equation solving
Numerical methods for integration
Numerical methods to solve stochastic problems

Monte Carlo simulation
Exercises
References and further reading

9 Optimization 307
Introduction
Linear programming
Constructing portfolios to minimize total variance
Constrained optimization
Exercises
References and further reading

10 Continuous time mathematics in finance: asset prices as a stochastic process 333
Introduction
The stochastic process of asset prices
Applying Ito's lemma to derivative pricing
Assumptions – the Ito process and lognormality
Exercises
References
Appendix

11 Multivariate analysis: principal components analysis and factor analysis 357
Introduction
Principal components analysis
Factor analysis
Exercises
References and further reading

Appendix: statistical tables 377
Areas of the standardized normal distribution
Percentage points of the t-distribution
Percentage points χ^2 distribution
F distribution
Durbin–Watson statistic

Index 387