

# Index

- Abnormal return, CAPM 253
- Absolute return 58
- Absolute risk tolerance 231
- Absolute value function 6
- Active return 92, 256
- Active risk 256
- Alternative hypothesis 124, 151
- American option 1, 215–16
- Amex case study 144–6, 153–5
- Amex Oil index 162–3, 169–70, 174
- Analysis of variance (ANOVA)
  - Amex case study 154
  - BHP Billiton Ltd case study 164–5
  - matrix notation 159–60
  - regression 143–4, 149–50
- Analytic solution 185
- Anderson–Darling test 128–9
- ANOVA (analysis of variance)
  - Amex case study 154
  - BHP Billiton Ltd case study 164–5
  - matrix notation 159–60
  - regression 143–4, 149–50
- Appraisal ratio 257
- Approximate confidence interval 122
- Approximations
  - delta–gamma 2, 34
  - delta–gamma–vega 34
  - duration–convexity 2–3, 34
  - finite difference 206–10, 223
- Arbitrage
  - no arbitrage 2, 179–80, 211–13
  - pricing theory 257
  - statistical strategy 182–3
- Arithmetic Brownian motion 22, 136, 138–9
- Arrival rate, Poisson distribution 87–9
- Ask price 2
- Asset management, global 225
- Asset prices
  - binomial theorem 85–7
  - lognormal distribution 213–14
  - pricing theory 179–80, 250–55
  - regression 179–80
  - stochastic process 137–8
- Assets, tradable 1
- Asymptotic mean integrated square error 107
- Asymptotic properties of OLS estimators 156
- Autocorrelation 175–9, 184, 259–62
- Autocorrelation adjusted Sharpe ratio 259–62
- Autoregression 135
- Auxiliary regression 177
- Backtesting 183
- Backward difference operator 19
- Bandwidth, kernel 106–7
- Bank 225
- Barra model 181
- Basic calculus 1–36
- Basis splines 200
- Bayesian probability 72–3
- Bermudan option 1
- Bernoulli trial 85–6
- Best fit of function to data 201
- Best fit line 145
- Best linear unbiased estimator (BLUE) 157, 175

- Beta values  
 CAPM 252–3  
 diversifiable risk 181  
 OLS estimation 147–8, 156, 160–1, 183–4  
 regression 156
- Bid–ask spread 2
- Bid price 2
- Bilinear interpolation 193–5
- Binomial distribution 85–7, 213
- Binomial lattices 186, 210–16, 223  
 American option 215–16  
 European option 212–13  
 lognormal asset price distribution 213–14  
 no arbitrage 211–12  
 risk neutral valuation 211–12
- Bisection method, iteration 187–8
- Bivariate distribution 108–9, 116–17, 148
- Bivariate normal distribution 116–17, 148
- Bivariate normal mixture distribution 116–17
- Black–Scholes–Merton pricing model  
 asset price 137–9  
 European option 2, 213, 215–16  
 lognormal distribution 94  
 numerical method 185  
 Taylor expansion 2–3
- BLUE (best linear unbiased estimator) 157, 175
- Bonds 1–2, 37, 191
- Bootstrap 218
- Brownian motion 136  
 arithmetic 22, 136, 139  
 geometric 21–2, 134, 138, 212, 213–14, 218–19
- Calculus 1–36  
 differentiation 10–15  
 equations and roots 3–9  
 financial returns 16–26  
 functions 3–9, 26–31  
 graphs 3–9  
 integration 15–16  
 Taylor expansion 31–4, 36
- Calibration 201
- Call option 1, 6, 212–13, 215–16
- Capital allocation, bank 225
- Capital asset pricing model (CAPM) 179–80, 252–5, 257–8
- Capital market line (CML) 250–2
- CAPM (capital asset pricing model) 179, 252–5, 257–8
- CARA (constant absolute risk aversion) 233–4
- Cartesian plane/space 39
- Case studies  
 Amex 144–6, 153–5  
 BHP Billiton Ltd 162–5, 168–70, 174–5, 177–8  
 credit risk 171–3  
 EM algorithm 203–6  
 PCA of European equity index 67–9  
 time series of asset price 218–20
- Cauchy distribution 105
- CBOE Gold index 162–3, 168–70, 174
- Central limit theorem 120–1
- Centre of location of distribution 78–9
- Certainty equivalence 227–9
- Characteristic equation 51–2
- Chi-squared distribution 100–1, 123–4
- Cholesky decomposition 37–8, 61–3, 70
- Cholesky matrix 62–3, 70, 220–2
- Circulant matrix 178
- Classical probability 72–3
- CML (capital market line) 250–2
- Coefficients  
 OLS estimators 155  
 regression 143–4, 151–2, 155, 168–9  
 risk aversion 231–4, 237  
 risk tolerance 233
- Cokurtosis, CAPM 255
- Complement, probability 73
- Complete market 212
- Compounding factor, returns 22–3
- Concave function 13–14, 35
- Conditional confidence interval 169
- Conditional distribution 108–9
- Conditional mean equation, OLS 148
- Conditional probability 73
- Conditional value at risk 105
- Confidence interval 72, 118–24, 167–70
- Conjugate gradient 193
- Consistent OLS estimators 156–8
- Constant absolute risk aversion (CARA) 233–4
- Constant relative risk aversion (CRRA) 232–4
- Constant term, regression 143–4
- Constrained optimization 29–31
- Constraint, minimum variance portfolio 245–6
- Continuous compounding, return 22–3
- Continuous distribution 114
- Continuous function 5–6, 35
- Continuous time 134–9  
 long-short portfolio 21  
 mean reverting process 136–7

- notation 16–17  
 P&L 19  
 random walks 136–7  
 stochastic process 134–9  
 Convergence, iteration 188–9  
 Convex function 13–14, 35  
 Copula 109–10  
 Correlation 111–14  
   beta value 147–8  
   simulation 220–2  
 Correlation matrix 38, 55–61, 70  
   eigenvalues/vectors 52–4, 59–61  
   PCA 64–5, 67–8, 70  
   positive definiteness 58–9  
 Coskewness, CAPM 255  
 Counting process 139  
 Coupon 1  
 Covariance 80, 110–2  
 Covariance matrix 37–8, 55–61, 70  
   eigenvalues/vectors 59–61  
   OLS estimation 159–60  
   PCA 64–5, 66–7, 70  
   positive definiteness 58–9  
 Cox–Ross–Rubinstein parameterization 215  
 Crank–Nicolson finite difference scheme 210  
 Credit risk case study 171–3  
 Criterion for convergence, iteration 188  
 Critical region, hypothesis test 124–5  
 Critical value 118–20, 122–3, 129  
 Cross-sectional data 144  
 CRRA (constant relative risk aversion) 232–4  
 Cubic spline 197–200  
 Cumulative distribution function 75  
 Currency option 195–7  
  
 Decision rule, hypothesis test 125  
 Decomposition of matrix 61–4  
 Definite integral 15–16  
 Definite matrix 37, 46–7, 54, 58–9, 70  
 Degrees of freedom, Student  $t$  distribution 97–8  
 Delta–gamma approximation 2–3, 34  
 Delta–gamma–vega approximation 34  
 Delta hedging 208, 211  
 Density function 75–7  
   binomial distribution 86  
   bivariate distribution 108–9  
   joint 114–15  
   leptokurtic 82–3  
   lognormal distribution 93  
   MLE 130–4  
   normal distribution 90–2, 97, 115–17  
   Poisson distribution 88  
   stable distribution 105–6  
   Student  $t$  distribution 97–100  
 Dependent variable 143  
 Derivatives 1–2  
   calculation 12–13  
   first 2, 10–11  
   partial 27–8, 35  
   second 2, 11, 13  
   total 31  
 Determinant 41–3, 47  
 Deterministic variable 75  
 Diagonalizable matrix 43  
 Diagonal matrix 40, 56  
 Dicky–Fuller test 136  
 Differentiable function 5–6, 35  
 Differential equations  
   partial 2, 208–10  
   stochastic 134, 136  
 Differentiation 10–15  
   concave/convex function 13–14  
   definition 10–11  
   monotonic function 13–14  
   rule 11–12  
   stationary point 14–15  
   stochastic differential term 22  
 Diffusion process, Brownian motion 22  
 Discontinuity 5  
 Discrete compounding, return 22–3  
 Discrete time 134–9  
   log return 19–20  
   notation 16–17  
   P&L 19  
   percentage return 19–20  
   random walk model 135  
   stationary/integrated process 134–6  
   stochastic process 134–9  
 Discretization of space 209–10  
 Discriminant 5  
 Distribution function 75–7  
 Diversifiable risk 181  
 DJIA (Dow Jones Industrial Average) index 137–8  
 Dot product 39  
 Dow Jones Industrial Average (DJIA) index 137–8  
 Dummy variable 175  
 Duration–convexity approximation 2–3, 34  
 Durbin–Watson autocorrelation test 176–7

- Efficiency, OLS estimators 156–7
- Efficient frontier 246–9, 251
- Efficient market hypothesis 179
- Eigenvalues/vectors 37–8, 48–54, 70
- characteristic equation 51–2
  - correlation matrix 52, 59–60
  - covariance matrix 59–61
  - definiteness test 54
  - definition 50–1
  - linear portfolio 59–61
  - matrices/transformations 48–50
  - properties 52–3
- Elliptical distribution 115
- EM (expectation–maximization algorithm) 203–6
- Empirical distribution 77, 217–18
- Enhanced indexation 182–3
- Epanechnikov kernel 107
- Equality of two mean 126–7
- Equality of two variance 126–7
- Equations 3–9
- CML 252
  - heat equation 208–9
  - partial differential 2, 208–10
  - quadratic 4–5
  - roots 187
  - simultaneous equations 44–5
- Equity index returns 96–7
- Equity price 172
- Equity volatility 172–3
- Error process 145, 148, 155
- ESS (explained sum of squares) 149–50, 159–62
- Estimation
- calibration 201
  - MLE 72, 130–4, 141, 202–3
  - OLS 143–4, 146–9, 153–63, 170–1, 176
- ETL (expected tail loss) 104–5
- European equity indices case study 67–9
- European options 1–2
- American option 215–16
  - binomial lattice 212–13
  - interpolation 195–6
  - pricing 212–13, 215–16
- Euro swap rate (1-year) 172
- Excel
- BHP Billiton Ltd case study 163–4
  - binomial distribution 213
  - chi-squared distribution 123–4
  - critical values 118–20, 122–3
  - Goal Seek 186, 188–9
  - histogram 77–8
  - matrix algebra 40, 43–6, 53–4, 59, 63–4, 68, 70
  - moments of a sample 82–3
  - multiple regression 163–4
  - normal probabilities 90–1
  - OLS estimation 153–5
  - percentiles 83–5
  - Poisson distribution 88
  - random numbers 89
  - simulation 217, 219
  - Solver 186, 190–1, 246
  - Student *t* distribution 100, 122–3
- Expectation–maximization (EM) algorithm 203–6
- Expected tail loss (ETL) 104–5
- Expected utility 227–8
- Expected value (expectation) 78–9
- Explained sum of squares (ESS) 149–50, 159–62
- Explanatory variables 143, 157, 170
- Explicit function 185
- Exponential distribution 87–9
- Exponential function 1, 7–9, 34–5, 233–7
- Exponential utility function 233–7
- Extrapolation 186, 193–200, 223
- Extreme value theory 101–3
- Factorial function 8
- Factorial notation 86
- Factor model software 181
- F* distribution 100–1, 127
- Feasible set 246
- Finance 1–36, 37–70, 185–223, 225–67
- Financial market integration 180–1
- Finite difference approximation 186, 206–10, 223
- first/second order 206–7
  - the Greeks 207–8
  - partial differential equations 208–10
- First difference operator, discrete time 17
- First order autocorrelation 178
- Forecasting 182, 254
- Forward difference operator, returns 19, 22
- Fréchet distribution 103
- F* test 127
- FTSE 100 index 204–5, 242–4
- Fully-funded portfolio 18

- Functions 3–9, 26–31  
   absolute value 6  
   concave 13–14, 35  
   continuous 5–6, 35  
   convex 13–14, 35  
   differentiable 5–6, 35  
   distribution function 75–7, 114–15  
   explicit/implicit 185  
   exponential 1, 7–9, 34–5, 234–7  
   factorial 8  
   gamma 97–8  
   indicator 6  
   inverse 6–7, 35  
   Lagrangian 29–30  
   likelihood 72, 130–4  
   linear 4–5  
   logarithmic 1, 9, 34–5  
   monotonic 13–14, 35  
   non-linear 1–2  
   objective 29, 188  
   quadratic 4–5, 233–4  
   several variables 26–31  
   utility 232–4  
 Fundamental theorem of arbitrage 212  
 Futures 1, 181–2, 194  
  
 Gamma function, Student  $t$  distribution 97–8  
 Gaussian copula 109–10  
 Gaussian kernel 107  
 Gauss–Markov theorem 157, 175, 184  
 Generalized extreme value (GEV) distribution 101–3  
 Generalized least squares (GLS) 178–9  
 Generalized Pareto distribution 101, 103–5  
 Generalized Sharpe ratio 262–3  
 General linear model, regression 161–2  
 Geometric Brownian motion 21–2  
   lognormal asset price distribution 213–14  
   SDE 134  
   stochastic process 141  
   time series of asset prices 218–20  
 GEV (generalized extreme value) distribution 101–3  
 Global asset management 225  
 Global minimum variance portfolio 244, 246–7  
 GLS (generalized least squares) 178–9  
 Goal Seek, Excel 186, 188–9  
 Gold index, CBOE 162–3, 168–70, 174  
 Goodness of fit 128, 149–50, 163–5, 167  
  
 Gradient vector 28  
 Graphs 3–9  
 The Greeks 207–8  
 Gumbel distribution 103  
  
 Heat equation 208  
 Hedging 2, 181–2  
 Hermite polynomials 200  
 Hessian matrix 28–30, 132, 192–3  
 Heteroscedasticity 173–9, 184  
 Higher moment CAPM model 255  
 Histogram 76–8  
 Historical data, VaR 106  
 Homoscedasticity 135  
 $h$ -period log return 23–4  
 Hyperbola 5  
 Hypothesis tests 72, 124–5  
   CAPM 254–5  
   regression 151–2, 163–6  
   Student  $t$  distribution 100  
  
 Identity matrix 40–1  
 i.i.d. (independent and identically distributed) variables  
   central limit theorem 121  
   error process 148  
   financial modelling 186  
   GEV distribution 101  
   regression 148, 157, 175  
   stable distribution 106  
   stochastic process 134–5  
 Implicit function 185  
 Implied volatility 194, 196, 200–1  
 Implied volatility surface 200–1  
 Incremental change 31  
 Indefinite integral 15  
 Independent events 74  
 Independent and identically distributed (i.i.d.) variables  
   central limit theorem 121  
   error process 148  
   financial modelling 186  
   GEV distribution 101  
   regression 148, 157, 175  
   stable distribution 106  
   stochastic process 134–5  
 Independent variable 72, 143  
   random 109–10, 115, 140  
 Index tracking regression model 182–3  
 Indicator function 6  
 Indices, laws 8

- Indifference curves 248–9  
 Inequality constraint, minimum variance portfolio 245–6  
 Inference 72, 118–29, 141  
   central limit theorem 120–1  
   confidence intervals 72, 118–24  
   critical values 118–20, 122–3, 129  
   hypothesis tests 124–5  
   means 125–7  
   non-parametric tests 127–9  
   quantiles 118–20  
   variance 126–7  
 Inflection points 14, 35  
 Information matrix 133, 203  
 Information ratio 257, 259  
 Instability, finite difference approximation 209–10  
 Integrated process, discrete time 134–6  
 Integration 3, 15–16, 35  
 Intensity, Poisson distribution 88  
 Interest rate 34, 171–3  
 Interest rate sensitivity 34  
 Interpolation 186, 193–200, 223  
   cubic spline 197–200  
   currency option 195–7  
   linear/bilinear 193–5  
   polynomial 195–7  
 Intrinsic value of option 215  
 Inverse function 6–7, 35  
 Inverse matrix 41, 43–4, 133  
 Investment bank 225  
 Investment 2, 256–7  
 Investor risk tolerance 230–1, 237  
 Irrational numbers 7  
 Isoquants 248  
 Iteration 186–93, 223  
   bisection method 187–8  
   gradient method 191–3  
   Newton–Raphson method 188–91  
 Itô's lemma 138–9, 219  
 iTraxx Europe credit spread index 172  
  
 Jacobian matrix 202  
 Jarque–Bera normality test 158  
 Jensen's alpha 257–8  
 Joint density function 114–15  
 Joint distribution function 114–15  
 Joint probability 73  
 Jumps, Poisson process 139  
  
 Kappa indices 263–5  
 Kernel 106–7  
 Kolmogorov–Smirnov test 128  
 Kuhn–Tucker conditions 30  
 Kurtosis 81–3, 94–6, 205–6  
  
 Lagrange multiplier (LM) test 124, 167  
 Lagrange multiplier 29–30, 244  
 Lagrangian function 29–30  
 Lattice 186, 210–16, 223  
 Laws of indices 8  
 Least squares  
   OLS estimation 143–4, 146–50, 153–61, 163, 170–1, 176  
   problems 201–2  
   weighted 179  
 Leptokurtic density 82–3  
 Levenberg–Marquardt algorithm 202  
 Lévy distribution 105  
 Likelihood  
   function 72, 130–31  
   MLE 72, 130–34, 141, 202–3  
   optimization 202–3  
   ratio test 124, 167  
 Linear function 4–5  
 Linear interpolation 193–5  
 Linear portfolios 33, 35  
   correlation matrix 55–60  
   covariance matrix 55–61  
   matrix algebra 55–61  
   P&L 57–8  
   returns 25, 56–8  
   variance 57  
   volatility 57–8  
 Linear regression 143–84  
 Linear restrictions, hypothesis tests 165–6  
 Linear transformation 48  
 Linear utility function 233  
 LM (Lagrange multiplier) 29–30, 124, 167, 244  
 Local maxima 14, 28–9  
 Local minima 14, 28–9  
 Logarithmic utility function 232  
 Logarithm, natural 1, 9, 34–5  
 Log likelihood 131–2  
 Lognormal distribution 93–4, 213–14, 218–20  
 Log returns 16, 19–25  
 Long portfolio 3, 17, 238–40  
 Long-short portfolio 17, 20–1  
 Low discrepancy sequences 217  
 Lower triangular square matrix 62, 64

- LR (likelihood ratio) test 124, 167  
LU decomposition, matrix 63–4
- Marginal densities 108–9  
Marginal distributions 108–9  
Marginal probability 73–4  
Marginal utility 229–30  
Market behaviour 180–1  
Market beta 250  
Market equilibrium 252  
Market maker 2  
Market microstructure 180  
Market portfolio 250–1  
Market risk premium, CAPM 253  
Markets  
    complete 212  
    regime-specific behaviour 96–7  
Markowitz, Harry 226, 238, 266  
Markowitz problem 200–1, 226, 244–5  
Matrix algebra 37–70  
    application 38–47  
    decomposition 61–4, 70  
    definite matrix 37, 46–7, 54, 58–9, 70  
    determinant 41–3, 47  
    eigenvalues/vectors 37–8, 48–54, 59–61, 70  
    functions of several variables 27–31  
    general linear model 161–2  
    hypothesis testing 165–6  
    invariant 62  
    inverse 41, 43–4  
    law 39–40  
    linear portfolio 55–61  
    OLS estimation 159–61  
    PCA 64–70  
    product 39–40  
    quadratic form 37, 45–6, 54  
    regression 159–61, 165–6  
    simultaneous equation 44–5  
    singular matrix 40–1  
    terminology 38–9  
Maxima 14, 28–31, 35  
Maximum likelihood estimation (MLE) 72,  
    130–4, 141, 202–3  
Mean confidence interval 123  
Mean excess loss 104  
Mean reverting process 136–7  
Mean 78–9, 125–6, 127, 133–4  
Mean square error 201  
Mean–variance analysis 238  
Mean–variance criterion, utility theory 234–7  
Minima 14, 28–31, 35  
Minimum variance portfolio 3, 240–7  
Mixture distribution 94–7, 116–17, 203–6  
MLE (maximum likelihood estimation) 72,  
    130–4, 141, 202–3  
Modified duration 2  
Modified Newton method 192–3  
Moments  
    probability distribution 78–83, 140  
    sample 82–3  
    Sharpe ratio 260–3  
Monotonic function 13–14, 35  
Monte Carlo simulation 129, 217–22  
    correlated simulation 220–2  
    empirical distribution 217–18  
    random numbers 217  
    time series of asset prices 218–20  
Multicollinearity 170–3, 184  
Multiple linear regression 158–74  
    confidence intervals 167–70  
    hypothesis testing 163–7  
    multicollinearity 170–3, 184  
    orthogonal 173–5  
Multivariate distributions 107–18, 140–1  
    bivariate 108–9, 116–17  
    bivariate normal mixture 116–17  
    continuous 114  
    correlation 111–14  
    covariance 110–2  
    independent random variables 109–10,  
        114  
    normal 115–17, 220–2  
    Student  $t$  117–18  
Multivariate linear regression 158–75  
    BHP Billiton Ltd 162–5, 169–70, 174–5  
    confidence interval 167–70  
    general linear model 161–2  
    hypothesis testing 163–6  
    matrix notation 159–61  
    multicollinearity 170–3, 184  
    multiple regression in Excel 163–4  
    OLS estimation 159–61  
    orthogonal regression 173–5  
    prediction 169–70  
    simple linear model 159–61  
Multivariate Taylor expansion 34  
Mutually exclusive events 73
- Natural logarithm 9, 34–5  
Natural spline 198  
Negative definite matrix 46–7, 54  
Newey–West standard error 176

- Newton–Raphson iteration 188–91  
 Newton’s method 192  
 No arbitrage 2, 179–80, 211–12  
 Non-linear function 1–2  
 Non-linear hypothesis 167  
 Non-linear portfolio 33, 35  
 Non-parametric test 127–9  
 Normal confidence interval 119–20  
 Normal distribution 90–2  
   Jarque–Bera test 158  
   log likelihood 131–2  
   mixtures 94–7, 140–1, 203–6  
   multivariate 115–16, 220–2  
   standard 218–19  
 Normalized eigenvector 51–3  
 Normalized Student  $t$  distribution 99  
 Normal mixture distribution 94–7,  
   116–17, 140–1  
   EM algorithm 203–6  
   kurtosis 95–6  
   probabilities of variable 96–7  
   variance 94–6  
 Null hypothesis 124  
 Numerical methods 185–223  
   binomial lattice 210–6  
   inter/extrapolation 193–200  
   iteration 186–93  
  
 Objective function 29, 188  
 Offer price 2  
 Oil index, Amex 162–3, 169–70,  
   174  
 OLS (ordinary least squares) estimation  
   143–4, 146–50  
   autocorrelation 176  
   BHP Billiton Ltd case study 163  
   heteroscedasticity 176  
   matrix notation 159–61  
   multicollinearity 170–1  
   properties of estimator 155–8  
   regression in Excel 153–5  
 Omega statistic 263–5  
 One-sided confidence interval 119–20  
 Opportunity set 246–7, 251  
 Optimization 29–31, 200–6, 223  
   EM algorithm 203–6  
   least squares problems 201–2  
   likelihood methods 202–3  
   numerical methods 200–5  
   portfolio allocation 3, 181  
  
 Options 1–2  
   American 1, 215–16  
   Bermudan 1  
   call 1, 6, 212–16  
   currency 195–7  
   European 1–2, 195–6, 212–13, 215–16  
   finite difference approximation 206–10  
   pay-off 6  
   plain vanilla 2  
   put 1, 212–16  
 Ordinary least squares (OLS) estimation  
   143–4, 146–50  
   autocorrelation 176  
   BHP Billiton Ltd case study 163  
   heteroscedasticity 176  
   matrix notation 159–61  
   multicollinearity 170–1  
   properties of estimators 155–8  
   regression in Excel 153–5  
 Orthogonal matrix 53–4  
 Orthogonal regression 173–5  
 Orthogonal vector 39  
 Orthonormal matrix 53  
 Orthonormal vector 53  
 Out-of-sample testing 183  
  
 P&L (profit and loss) 3, 19  
   backtesting 183  
   continuous time 19  
   discrete time 19  
   financial returns 16, 19  
   volatility 57–8  
 Pairs trading 183  
 Parabola 4  
 Parameter notation 79–80  
 Pareto distribution 101, 103–5  
 Parsimonious regression model 153  
 Partial derivative 27–8, 35  
 Partial differential equation 2, 208–10  
 Pay-off, option 6  
 PCA (principal component analysis) 38,  
   64–70  
   definition 65–6  
   European equity indices 67–9  
   multicollinearity 171  
   representation 66–7  
 Peaks-over-threshold model 103–4  
 Percentage returns 16, 19–20, 58  
 Percentile 83–5, 195  
 Performance measures, RAPMs 256–65  
 Period log returns 23–5

- 
- Pi 7
  - Piecewise polynomial interpolation 197
  - Plain vanilla option 2
  - Points of inflexion 14, 35
  - Poisson distribution 87–9
  - Poisson process 88, 139
  - Polynomial interpolation 195–7
  - Population mean 123
  - Portfolio allocation 237–49, 266
    - diversification 238–40
    - efficient frontier 246–9, 251
    - Markowitz problem 244–5
    - minimum variance portfolio 240–7
    - optimal allocation 3, 181, 247–9
  - Portfolio holdings 17–18, 25–6
  - Portfolio mathematics 225–67
    - asset pricing theory 250–55
    - portfolio allocation 237–49, 266
    - RAPMs 256–67
    - utility theory 226–37, 266
  - Portfolios
    - bond portfolio 37
    - delta-hedged 208
    - linear 25, 33, 35, 55–61
    - non-linear 33, 35
    - rebalancing 17–18, 26, 248–9
    - returns 17–18, 20–1, 91–2
    - risk factors 33
    - risk free 211–12
    - stock portfolio 37
  - Portfolio volatility 3
  - Portfolio weights 3, 17, 25–6
  - Positive definite matrices 37, 46–7, 70
    - correlation matrix 58–9
    - covariance matrix 58–9
    - eigenvalues/vectors 54
    - stationary point 28–9
  - Posterior probability 74
  - Post-sample prediction 183
  - Power series expansion 9
  - Power utility functions 232–3
  - Prediction 169–70, 183
  - Price discovery 180
  - Prices
    - ask price 2
    - asset price evolution 87
    - bid price 2
    - equity 172
    - generating time series 218–20
    - lognormal asset prices 213–14
    - market microstructure 180
    - offer price 2
    - stochastic process 137–9
  - Pricing
    - arbitrage pricing theory 257
    - asset pricing theory 179–80, 250–55
    - European option 212–13
    - no arbitrage 211–13
  - Principal cofactors, determinants 41
  - Principal component analysis (PCA) 38, 64–70
    - definition 65–6
    - European equity index 67–9
    - multicollinearity 171
    - representation 66–7
  - Principal minors, determinants 41
  - Principle of portfolio diversification 240
  - Prior probability 74
  - Probability and statistics 71–141
    - basic concepts 72–85
    - inference 118–29
    - laws of probability 73–5
    - MLE 130–4
    - multivariate distributions 107–18
    - stochastic processes 134–9
    - univariate distribution 85–107
  - Profit and loss (P&L) 3, 19
    - backtesting 183
    - continuous time 19
    - discrete time 19
    - financial returns 16, 19
    - volatility 57–8
  - Prompt futures 194
  - Pseudo-random numbers 217
  - Put option 1, 212–13, 215–16
  
  - Quadratic convergence 188–9, 192
  - Quadratic form 37, 45–6, 54
  - Quadratic function 4–5, 233
  - Quantiles 83–5, 118–20, 195
  - Quartiles 83–5
  - Quasi-random numbers 217
  
  - Random numbers 89, 217
  - Random variables 71
    - density/distribution function 75
    - i.i.d. 101, 106, 121, 135, 148, 157, 175
    - independent 109–10, 116, 140–1
    - sampling 79–80
  - Random walks 134–7
  - Ranking investments 256

- RAPMs (risk adjusted performance measures)  
 256–67  
 CAPM 257–8  
 kappa indices 263–5  
 omega statistic 263–5  
 Sharpe ratio 250–1, 252, 257–63, 267  
 Sortino ratio 263–5
- Realization, random variable 75
- Realized variance 182
- Rebalancing of portfolio 17–18, 26, 248–9
- Recombining tree 210
- Regime-specific market behaviour 96–7, 117
- Regression 143–84  
 autocorrelation 175–9, 184  
 financial applications 179–83  
 heteroscedasticity 175–9, 184  
 linear 143–84  
 multivariate linear 158–75  
 OLS estimator properties 155–8  
 simple linear model 144–55
- Relative frequency 77–8
- Relative risk tolerance 231
- Representation, PCA 66–7
- Residuals 145–6, 157, 175–8
- Residual sum of squares (RSS) 146, 148–50,  
 159–62
- Resolution techniques 185–6
- Restrictions, hypothesis testing 165–7
- Returns 2–3, 16–26  
 absolute 58  
 active 92, 256  
 CAPM 253–4  
 compounding 22–3  
 continuous time 16–17  
 correlated simulations 220  
 discrete time 16–17, 22–5  
 equity index 96–7  
 geometric Brownian motion 21–2  
 linear portfolio 25, 56–8  
 log returns 16, 19–25  
 long-short portfolio 20–1  
 multivariate normal distribution 115–16  
 normal probability 91–2  
 P&L 19  
 percentage 16, 19–20, 59–61  
 period log 23–5  
 portfolio holdings/weights 17–18  
 risk free 2  
 sources 25–6  
 stochastic process 137–9
- Ridge estimator, OLS 171
- Risk  
 active risk 256  
 diversifiable risk 181  
 linear portfolio 56–7  
 systematic risk 181, 250, 252
- Risk adjusted performance measure (RAPM)  
 256–67  
 CAPM 257–8, 266  
 kappa indices 263–5  
 omega statistic 263–5  
 Sharpe ratio 251, 252, 257–63, 267  
 Sortino ratio 263–5
- Risk averse investor 248
- Risk aversion coefficients 231–4, 237
- Risk factor sensitivities 33
- Risk free investment 2
- Risk free portfolio 211
- Risk free returns 2
- Risk loving investors 248–9
- Risk neutral valuation 211–12
- Risk preference 229–30
- Risk reversal 195–7
- Risk tolerance 230–1, 237
- Robustness 171
- Roots 3–9, 187
- RSS (residual sum of squares) 146, 148–50,  
 159–62
- S&P 100 index 242–4
- S&P 500 index 204–5
- Saddle point 14, 28
- Sample 76–8, 82–3
- Sampling distribution 140
- Sampling random variable 79–80
- Scalar product 39
- Scaling law 106
- Scatter plot 112–13, 144–5
- SDE (stochastic differential equation) 22, 134,  
 136
- Security market line (SML) 253–4
- Self-financing portfolio 18
- Sensitivities 1–2, 33–4
- Sharpe ratio 257–63, 267  
 autocorrelation adjusted 259–62  
 CML 251, 252  
 generalized 262–3  
 higher moment adjusted 260–2  
 stochastic dominance 258–9
- Sharpe, William 250
- Short portfolio 3, 17
- Short sales 245–7

- Short-term hedging 182
- Significance level 124
- Similarity transform 62
- Similar matrices 62
- Simple linear regression 144–55
  - ANOVA and goodness of fit 149–50
  - error process 148–9
  - Excel OLS estimation 153–5
  - hypothesis tests 151–2
  - matrix notation 159–61
  - OLS estimation 146–50
  - reporting estimated model 152–3
- Simulation 186, 217–22
- Simultaneous equations 44–5
- Singular matrix 40–1
- Skewness 81–3, 205–6
- Smile fitting 196–7
- SML (security market line) 253–4
- Solver, Excel 186, 190–1, 246
- Sortino ratio 263–5
- Spectral decomposition 60–1, 70
- Spline interpolation 197–200
- Squares matrix 38, 40–2, 61–4
- Square-root-of-time scaling
  - rule 106
- Stable distribution 105–6
- Standard deviation 80, 121
- Standard error 80, 169
  - central limit theorem 121
  - mean/variance 133–4
  - regression 148–9
  - White’s robust 176
- Standard error of the prediction 169
- Standardized Student  $t$  distribution 99–100
- Standard normal distribution 90, 218–19
- Standard normal transformation 90
- Standard uniform distribution 89
- Stationary point 14–15, 28–31, 35
- Stationary stochastic process 111–12, 134–6
- Stationary time series 64–5
- Statistical arbitrage strategy 182–3
- Statistical bootstrap 218
- Statistics and probability 71–141
  - basic concepts 72–85
  - inference 118–29
  - laws of probability 73–5
  - MLE 130–4
  - multivariate distribution 107–18
  - stochastic process 134–9
  - univariate distribution 85–107
- Step length 192
- Stochastic differential equation (SDE) 22, 134, 136
- Stochastic dominance 227, 258–9
- Stochastic process 72, 134–9, 141
  - asset price/returns 137–9
  - integrated 134–6
  - mean reverting 136–7
  - Poisson process 139
  - random walks 136–7
  - stationary 111–12, 134–6
- Stock portfolio 37
- Straddle 195–6
- Strangle 195–7
- Strictly monotonic function 13–14, 35
- Strict stochastic dominance 258
- Structural break 175
- Student  $t$  distribution 97–100, 140
  - confidence intervals 122–3
  - critical values 122–3
  - equality of means/variances 127
  - MLE 132
  - multivariate 117–18
  - regression 151–3, 165, 167–8
  - simulation 220–2
- Sum of squared residuals, OLS 146
- Symmetric matrix 38, 47, 52–4, 61
- Systematic risk 181, 250, 252
- Tail index 102, 104
- Taylor expansion 2–3, 31–4, 36
  - applications 33–4
  - approximation 31–4, 36
  - definition 32–3
  - multivariate 34
  - risk factor sensitivities 33
- Theory of asset pricing 179–80, 250–55
- Tic-by-tic data 180
- Time series
  - asset prices/returns 137–9, 218–20
  - lognormal asset prices 218–20
  - PCA 64–5
  - Poisson process 88
  - regression 144
  - stochastic process 134–9
- Tobin’s separation theorem 250
- Tolerance levels, iteration 188
- Tolerance of risk 230–1, 237
- Total derivative 31
- Total sum of square (TSS) 149, 159–62

- Total variation, PCA 66  
Tower law for expectations 79  
Trace of matrix 62  
Tradable asset 1  
Trading, regression model 182–3  
Transition probability 211–13  
Transitive preferences 226  
Transpose of matrix 38  
Trees 186, 209–11  
Treyner ratio 257, 259  
TSS (total sum of squares) 149, 159–62  
Two-sided confidence interval 119–21
- Unbiased estimation 79, 81, 156–7  
Uncertainty 71  
Unconstrained optimization 29  
Undiversifiable risk 252  
Uniform distribution 89–90  
  use in simulation 217–18  
Unit matrix 40–1  
Unit vector 46  
Univariate distribution 85–107, 140  
  binomial 85–7, 212–13  
  exponential 87–9  
  generalized Pareto 101, 103–5  
  GEV 101–3  
  kernel 106–7  
  lognormal 93–4, 213–14, 218–20  
  normal 90–7, 115–16, 131–2, 140, 157–8, 203–6, 217–22  
  normal mixture 94–7, 140, 203–6  
  Poisson 87–9  
  sampling 100–1  
  stable 105–6  
  Student  $t$  97–100, 122–3, 126, 132–3, 140–1, 151–3, 165–8, 220–2  
  uniform 89–90  
Upper triangular square matrix 62, 64  
Utility theory 226–37, 266  
  mean–variance criterion 234–7  
  properties 226–9  
  risk aversion coefficient 231–4, 237  
  risk preference 229–30  
  risk tolerance 230–1, 237
- Value at risk (VaR) 104–6, 185, 194  
Vanna–volga interpolation method 196  
Variance  
  ANOVA 143–4, 149–50, 154, 159–60, 164–5  
  confidence interval 123–4  
  forecasting 182  
  linear portfolio 57  
  mean–variance criterion 234–36  
  minimum variance portfolio 3, 240–7  
  mixture distribution 94–6  
  MLE 133  
  normal mixture distribution 95–6  
  probability distribution 79–81  
  realized 182  
  tests on variance 126–7  
VaR (value at risk) 104–6, 185, 194  
Vector notation, functions of several variables 28  
Vectors 28, 37–9, 48–54, 59–61, 70  
Venn diagram 74–5  
Volatility  
  equity 3, 172–3  
  implied volatility 194, 196–7, 200–1  
  interpolation 194, 196–7  
  linear portfolio 57–8  
  long-only portfolio 238–40  
  minimum variance portfolio 240–4  
Vstox index 172
- Waiting time, Poisson process 88–9  
Wald test 124, 167  
Weakly stationary process 135  
Weak stochastic dominance 258–9  
Weibull distribution 103  
Weighted least squares 179  
Weights, portfolio 3, 17, 25–6  
White’s heteroscedasticity test 177–8  
White’s robust standard errors 176  
Wiener process 22, 136
- Yield 1, 197–200
- Zero matrix 39  
Z test 126



