Accuracy ratio, 221
Adams, Brandon, 395
Aggregation process, 297
Ainsley, Craig, 258–259, 261
Algorithmic Trading and DMA (Johnson), 396
Algren, Nelson, 395
All the Devils Are Here (McLean and Nocera), 399
Allen, Franklin, 396
Anderson, Chris, 399
Anomalies, 159–160
Anthropology of Economy, The (Gudeman), 394
Arbitrage, 164–167, 171, 258, 260, 262, 330
Ariely, Dan, 398
Ars Conjectandi (Bernoulli), 325, 327
Augar, Philip, 395
Autocorrelation, 260
Bacharach, Michael, 398
Back office, 225–227
Backward-looking risk management, 228–230
Bad-boy publicity, 347–348
Bad Bet (O’Brien), 395
Bankers Trust, 225, 266
Bank for International Settlements, 352
Bank One, 291
Barter, Exchange and Value (Humphrey and Hugh-Jones), 394
Bayes, Thomas, 327
Bayesians/Bayesian concepts. See also Probability
betting/probability and and, 10, 18, 328
foundation of, 59–60, 65
frequentism and, 12, 327
in history/law, 58
“prior beliefs” and, 261, 262
risk defining capital, 350
technology startups and, 367–368
Beat the Dealer (Thorp), 67
Beat the Market (Thorp and Kassouf), 67
Behavioral Game Theory (Camerer), 398
Bennet, Rick, 395
Bernoulli, Jakob, 325–327, 336, 343
Berns, Gregory, 398
Bernstein, Peter, 395
Betting:
Kelly bets, 262, 342
probability and, 10, 15–18, 328
public, 337
sports, 63–66, 349, 367
Beyond Counting (Grosjean), 395
Beyond Individual Choice (Bacharach), 398
Big Short, The (Lewis), 399
Black, Alethea, 396
Black, Fischer, 51, 60, 238, 255–256, 329, 395–396
Black-Scholes-Merton model, 329, 331–332
Black Swan, The (Taleb), 32, 393
Black Wednesday, 52
Bloom, Murray Teigh, 95
Bogle, John, 297
Bond ratings, 263, 293–294
Bookstaber, Richard, 393
Born Losers (Sandage), 395
Bounds of Reason, The (Gintis), 398
Brenner, Reuven and Gabrielle, 395
Bringing Down the House (Mezrich), 63
British Treasury, 52–53
Broke, (Adams) 395
Bronze Age, 136, 137
Bronze Age Economics (Earle), 394
Bubble investors, 106, 111, 112, 116, 191
Bulls, Bears, and Brains (Leitzes), 399
Burton, Robert Alan, 398
Business Cycles and Equilibrium (Black), 396
Busting Vegas (Mezrich), 63
Calvet, Laurent E., 396
Camerer, Colin 398
Capital:
  allocation, 359–362
  at-risk, 266
  formation, 359–360
  requirement, 350–352
Capital asset pricing model (CAPM), 88–92, 96–97
Capital Ideas (Bernstein), 395
Capital Offense (Hirsh), 399
Carnap, Rudolph, 59
Cash, Lehman Brothers and, 197–198
Cash Nexus (Ferguson), 394
Chance, Luck, and Statistics (Levinson), 394
Chances Are (Kaplan), 394
Change of numeraire, 42–43, 333–336
Checklist Manifesto, The (Gawande), 398
Chernow, Ron, 395
Chicago Board Options Exchange Volatility Index (VIX), 229
Chief risk officer (CRO), 215
Chiles, James, 398
Cincinnati Kid, The (Jessup), 395
Citibank, 225, 266
Clearinghouses, 196–197
CMOs. See Collateralized mortgage obligations (CMOs)
Cohen, Muhammad, 399
Cohen, William, 399
Coherent Stress Testing (Rebonato), 397
Collateralized mortgage obligations (CMOs), 257–258
Commodity futures, 79–84
Company of Strangers, The (Seabright), 394
Complete TurtleTrader, The (Covel), 297
Connor, Gregory, 397
Conquering Risk (Feustel), 395
Controllers/comptrollers, 224
Covel, Michael, 397
Cowboys Full (McManus), 395
Cox, Richard, 327
Cramer, Jim, 348
Credit derivatives, 362
Credit stress test, 285, 292
CRO. See Chief risk officer (CRO)
Danger, opportunity and, 2–4
Death of the Banker, The (Chernow), 395
Debt monetization, 349
Declining marginal utility, 41
de Condorcet (Marquis), 59
de Finetti, Bruno, 10, 327, 328, 394
Degree of belief. See Bayesians/
Bayesian concepts: Frequency
vs. degree of belief
Demon of Our Own Design,
A, (Bookstaber), 393
Derivatives/derivative money:
capital creation and, 349
clearinghouses, 186, 192, 196–197
definition, 331
derivative money, 186, 188–196,
200–203
energy sector and, 184–185
exposure from derivatives, 266
liquidity and, 191
as the new money, 185–189
numeraire and, 191–196
spread trade and, 183
as store of value, 187
Derivatives Models on Models
(Haug), 396
Derman, Emanuel, 396
Desrosières, Alain, 397
Dexter, Andrew, 147–149
Diogenes, 247
Disintermediation, 361
Dissertation (Brown), 258–262
Dorner, Dietrich, 243, 398
Drobný, Steven, 397
Druckenmiller, Stanley, 52
Duffie, Darrell, 399

Earle, Timothy, 394
Economic Function of Futures Markets,
The (Williams), 397
Economics of Risk and Time,
The (Gollier), 397
Econophysics, 46
Education of a Speculator,
The (Niederhoffer), 297
Efficient markets hypothesis
(EMH), 86–88
Efficient markets theory:
empirical evidence, 158–159
equilibrium price and, 162–165
father of efficient markets, 162
generally, 157–159
market inefficiencies and, 162
misrepresentations and, 161
myth about, 157–158, 160
Efron, Brad, 51, 394
Eichengreen, Barry, 395
Einhorn, David, 397
Eisenhower, Dwight, 53
Emergence of Probability,
The (Hacking), 394
EMH. See Efficient markets
tohypothesis (EMH)
Energy industry, 168–169, 184–185
Engle, Rob, 259, 261
Equilibrium, 88, 162–165
eRaider.com, 92–96, 239
Errors/error rates, 234–236
ETFs. See Exchange-traded funds
(ETFs)
Evans, Dylan, 218, 393
Evolution, 45–48, 128
EWMA. See Exponentially weighted
moving average (EWMA)
Exchange, 126–128, 129–130,
131, 154
Exchange Artist, The (Kamensky),
395
Exchange-traded funds
(ETFs), 172
Exorbitant Privilege
(Eichengreen), 395
Expected Returns (Ilmanen), 396
Expected value, 41
Exploratory Data Analysis
(Tukey), 394
Exploring General Equilibrium
(Black), 395
Exponentially weighted moving
average (EWMA), 273
Exponentials. See also Tulips/tulipomania
- AIDS and, 104–105
- culture and, 18–20
- growth and, 102–105
- negative, 105–106
- risk and, 101–102
Extraordinary Popular Delusions and the Madness of Crowds (Mackay), 106–107

Faith, Curtis, 297
Falkenstein, Eric, 396
Fama, Eugene, 162
Fannie May (Federal National Mortgage Agency), 292
Fat tails, 260–261
FCM. See Futures commission merchant (FCM)
Federal Reserve, 53, 197
Ferguson, Niall, 394
Feustel, Elihu, 395
Financial activity, social value of, 156–157
Financial crisis:
- failure to prevent, 290–296
- leverage limits and, 353
- main reason for, 348
- market-to-market accounting and, 350
- risk takers and, 364–365
Financial markets, functions of:
- capital allocation, 359–362
- capital formation, 359–360
- price discovery, 362–364
Financial scandals, 346–347, 359–360
Financing the Future (Allen and Yago), 396
Finding Alpha (Falkenstein), 396
Fischer Black and the Revolutionary Idea of Finance (Mehrling), 395
Flaw of Averages, The (Savage, Sam), 394
Fool’s Gold (Tett), 399
Fooled by Randomness (Taleb), 32, 393
Fooling Some of the People All of the Time (Einhorn), 297
Foreign exchange (FX), 257, 266
“Fortune’s formula,” 19
Fortune’s Formula (Poundstone), 393–394
Foundations of Statistics, The (Savage, Jimmy), 394
Founding Fathers, 147
Fox, Justin, 395
Freddie Mac/FHLMC (Federal Home Loan Mortgage Corporation), 292
Free (Anderson), 399
French, Kenneth, 398
Frequency vs. degree of belief:
- Bayesians and, 327–328
- beliefs vs. preferences, 323, 325
- change of numeraire, 333–336
- Fermat and Pascal, 323–324
- hypothetical random processes, 325–327
- moneylike nature, 328–329
- political polling, 336–341
- quant revolution, 341–343
- statistical games, 324–329
- Thorp, Black, Scholes, Merton, 329–332
Frequentism:
- dual-class share arbitrage, 164–165, 166–168
- frequentists vs. Bayesians, 11–13
Friedman, Milton, 76
Front-office risk manager, 215–217, 220–221
Fudenberg, Drew, 398
Futures commission merchant (FCM), 196
Futures contracts, 179–183, 195
FX. See Foreign exchange (FX)

Galbraith, John Kenneth, 359
Gambling, 8, 9, 14, 17, 58, 62–63, 130
Gambling and Speculation (Brenner and Brown), 395

Game theory:
causality and, 51
data collection, 49–50
decision maker identity, 54
human psychology, 54–55
practical example, 50
“Prisoner’s Dilemma”, 53, 55
randomness and, 51–52
risk management and, 49–55
story of money and, 126, 128
GARCH. See Generalized autoregressive conditional heteroskedasticity (GARCH)

Gasoline:
crack spread, 168–169
rationing project, 241–245
Gawande, Atul, 398

Generalized autoregressive conditional heteroskedasticity (GARCH), 259, 261

Ginnie Mae. See Government National Mortgage Association (GNMA)

Gintis, Herbert, 398

Glass-Steagall, 345

Goldberg, Lisa, 397
Goldstein, Phil, 95
Gollier, Christian, 397

Government:
bailout, 292
depression, 138–143
politics and, 151–152
religion and, 154

Government National Mortgage Association (GNMA), 170–172

Great Depression, 293, 294

Great Transformation,
The (Polanyi), 394

Greed Merchants, The (Augar), 395
Gregory, C. A., 394
Griffin, Peter, 395
Grosjean, James, 395

Growth, types of, 102–105
Gudeman, Stephen, 394

Hacking, Ian, 394
Handbook of Portfolio Mathematics, The (Vince), 396

Happiness (McMahon), 398

Haug, Espen, 396

Hayek, F. A., 50

Hedge funds, 78, 83, 96, 97, 99, 266, 367
Herbert, Zbigniew, 108, 109, 399

Heteroskedasticity, 259–261

Hirsh, Michael, 399

Historical simulation VaR, 271–273, 274–275

History of Statistics, The (Stigler), 394
Hoffer, Richard, 395

Hong Kong on Air (Cohen, Muhammad), 399
House of Cards (Cohan, William), 399

How Big Banks Fail and What to Do about It (Duffie), 399
Hugh-Jones, Stephen, 394
Humphrey, Caroline, 394

Iceberg Risk (Osband), 393

IGT. See Investment growth theory (IGT)
Ilmanen, Antti, 396
Implied volatility, 331–332
Index funds, 158
Inflation, 115, 146, 181, 190, 247
*Inside the Black Box* (Narang), 396
*Inside the House of Money* (Drobný), 397
Internet. See Bubble investors
Investment growth theory (IGT):
  EMH and, 86–87
  equations, MPT and IGT CAPM, 88–89
  fairness and, 98–99
  IGT CAPM and MPT CAPM, 89–92, 96
  virtues of, 84–86
*Inviting Disaster* (Chiles), 398
*Is God a Mathematician?* (Livio), 394
*Jackknife, the Bootstrap, and Other Resampling Plans, The* (Efron), 394
*Jackpot Nation* (Hoffer), 395
Jessup, Richard, 395
*John Bogle on Investing* (Bogle), 397
Johnson, Barry, 396
Johnson, Simon, 395
JPMorgan, 224–225, 226, 266, 269, 291, 292
Junk bonds, 293
Kelly, John, 19, 35, 67, 73, 74–76, 80, 84–85
Kelly bets/levels of risk, 262, 296–297, 342
Kelly principles/investors, 173, 174
Keynes, John Maynard, 283, 328
Key performance indicators (KPIs), 248–249
Key risk indicators (KRIs), 248
*King of a Small World* (Bennet), 395
Korajczyk, Robert, 397
Knetsch, Jack, 126
Knight, Frank, 59, 328
Kraitchik, Maurice, 333–334
Krüger, Lorenz, 60
Laplace, Pierre-Simon, 327
Lehman Brothers, 197–200, 291
Leitzes, Adam, 399
Lepercq de Neuflize, 172
Leverage, 294, 295, 353, 363
Levine, David, 398
Levinson, Horace, 394
Lewis, Michael, 399
*Limits of Safety, The* (Sagan), 398
Liquidity, 294, 351, 361–362, 363–364
Livio, Mario, 394
*Logic of Failure, The* (Dorner), 397
*Long-Run Collaboration on Games with Long-Run Patient Players, A* (Fudenberg and Levine), 398
Loss aversion, 126
Lowenstein, Roger, 399
Mackay, Charles, 106–107, 109, 110, 112
Madoff, Bernie, 360
Mallaby, Sebastian, 397
*Man with the Golden Arm, The* (Bennet), 395
Managed futures, 168
Managing risk, 296–298
Mandelbrot, Benoit, 396
Market:
  “beating” the, 165–169
  efficiency, 156–157 (see also Efficient markets theory)
equilibrium (see Equilibrium)
portfolio, 81
prices, 161–162, 168–169
return, 158–159
sympathy, 114
Mark-to-market accounting, 350, 352
Markowitz, Harry, 73, 80–81, 83–84, 85. See also Modern portfolio theory (MPT)
McLean, Bethany, 399
McMahon, Darrin, 398
McManus, James, 395
Medici Money (Park), 394
Mehrling, Perry, 395
Merck, 173
Merrill Lynch, 291, 347
Merton, Robert, 255, 329
Mezrich, Ben, 63
Middle office, 222–225, 227–228, 230–232
Mihm, Stephen, 395
(Mis)behavior of Markets, The (Mandelbrot), 396
Modern portfolio theory (MPT), 76–78, 84–85, 86, 96–99
Momentum investors, 195
Momentum trading, 168
Money. See also Paper money; Story of money
derivative money, 189, 191–196, 200–203
functions of, 185, 187–188
general theory of, derivatives and, 185–189
issuance, competition and, 193
play and, 9–11
reasons to hold, 187
risk management and, 38–45
token and commodity, 132
tulipomania and, 111–112, 115
Moneyness, 332
Moore’s law, 105
More Money Than God (Mallaby), 397
Morgan Stanley, 291
Mortgage securities, 170–171, 362
Mosteller, Frederick, 51
MPT. See Modern portfolio theory (MPT)
MPT CAPM, 88–92, 96–98
MSCI Barra, 270
Multifractal Volatility (Calvet), 396
My Life as a Quant (Derman), 396
Myth of the Plan, The (Rutland), 398
Myth of the Rational Market, The (Fox), 395
Narang, Rishi K., 396
NASDAQ index, 94, 305, 306
Nation of Counterfeiters, A, (Mihm) 395
New Financial Order, The (Shiller), 396
New Lombard Street, The (Mehrling), 395
Niederhoffer, Victor, 397
No Reserve: The Limit of Absolute Power (Redado), 53
Nocera, Joe, 399
Nonmoney exchange, 39
Nonparametric methods, 263, 264
Normal Accidents (Perrow), 398
Numeraire(s). See also Change of numeraire
definition, 11
derivative money, 191–195
diversity of, 193–194
economic value and, 194–195
market return and, 158
money as, 187–188
O’Brien, Tim, 395
Off-balance-sheet items, 352
On Being Certain (Burton), 398
Opportunity, danger and, 2–4
Options, smile and skew, 256–257
Origins of the Crash (Lowenstein), 399
Osband, Kent, 393
Pairs trading, 171
Paleonomics, 128–131
Paper money:
  clearing mechanisms, 185–186
  end of, 203–205, 247
  for loans, 140
  government and, 138–143
  vs. precious metal, 142–145
  replacement for, 179, 183
Parametric VaR, 273–274, 276
Park, Tim, 394
Pascal, Blaise:
  bets, dice throws and, 29, 61–62, 325, 330, 343
  letters to Fermat, 323–324
  Pascal’s wager, 29–32, 42–43, 47, 335
  religion, risk and, 150
  utility maximization and, 43
  Wall Street and, 58–61
Patterson, Scott, 396
Paul Wilmott Introduces Quantitative Finance (Wilmott), 396
Performance ratio, 221
Perrow, Charles, 398
Petroski, Henry, 398
Pfizer, 173
Philosophical Lectures on Probability (de Finetti), 394
Pilkey, Orrin, 398
Play, 1, 2, 8, 9–11, 18
Plight of the Fortunetellers (Rebonato), 397
Poisson, Siméon, 59
Poker, 61–62, 246
Poker player types, 219, 220
Polanyi, Karl, 394
Politics:
  election polling, 336–341
  religion and, 150–154
Politics of Large Numbers, The (Desrosières), 397
Porter, Theodore, 397
Portfolio Risk Analysis (Connor, Goldberg, and Korajczyk), 397
Portfolio Selection (Markowitz), 77
Poundstone, William, 394
Predictably Irrational (Ariely), 398
Price discovery, 363
Probability. See also Bayesians/Bayesian concepts
  field of, 59
  as long-term frequency, 326
  outcomes/utility of outcomes, 60
  risk-neutral distribution, 332
  “rocket scientists” and, 17–18
  theory, 51, 333–334 (see also Frequentism)
Product placement, 110
Professional standards, 213–215
Profit and loss:
  distribution, holes in, 289–290
  looking beyond, 232–234
Property exchange, money and, 126–128
Public betting, 337–340
Qualitative managers, 33
Quantitative modeling, 151
Quants/quantitative managers:
  old-school/new-school, 173–174
  revolution, 341–343
  stock market crashes and, 33
  three camps of, 219
  to Wall Street, 66–68
Quants, The (Patterson), 396
Quine, W. V. O., 60
Randomness/randomness theory:
  deliberately introducing, 326
  in evolution, 35, 42, 45–47, 48, 51
  game theory and, 49–50, 51, 52, 324–325
  superposition and, 48
Rational Optimist, The (Ridley), 394
Rationality, 13–15
Index 413

Real estate investment trust (REIT), 93
Rebonato, Riccardo, 397
Redado, Martin, 53
Refrigeration experiment, 243
REIT. See Real estate investment trust (REIT)
Religion, politics and, 150–154
Resampling, 260
Reserve requirements, 350–351
Retirement plans, 348
Ridley, Matt, 394
Risk:
    analysis, major complication in, 44
    -based capital, birth of, 350
    control, 224, 225, 230–232, 265
    culture and, 19–20
    danger, opportunity and, 2–4
    duality, 32, 33, 38
    ignition, 35–38, 102
    levels/limits, 297, 298
    life and, 7–9
    management, 4–7 (see also
        Seven principles of risk
        management)
    neutral probability distribution, 332
    optimizing, 10
    property and, 127–128
    story of, 315–321
    story of money and, 135–138
    strategy, 298
    types of, 225–226
    weights, 352
Risk Intelligence (Evans), 218, 393
Risk managers:
    back office, 225–227
    backward-looking risk
        management, 228–230
    bad numbers and, 236–238
    beyond profit and loss, 232–234
    creating risk, 309–312
    errors/error rates and, 234–236
    front office, 215–217
    gas rationing project, 241–245
    making sure firms fail, 299–305
    middle office, 222–225, 227–228
    poker playing and, 245–247
    professional standards, 213–215
    quants on job, 218–222
    risk control, 230–232
    trading risk and, 217–218
    validation and, 247–249
    waste and, 238–241
RiskMetrics, 270, 273, 275
Risk takers:
    iron rules for, 7–8
    vs. risk avoiders, 366–368
    “Rocket scientists:”
        probability and, 17–18
        quants as, 5–6, 10, 11, 15
        real finance and, 69
        “risk ignition,” 102
        Wall Street and, 57, 62, 66–67,
        69, 71
Rogues to Riches (Bloom), 95
Rumsfeld, Donald, 59
Rutland, Peter, 398
Sagan, Scott Douglas, 398
Sahlins, Marshall, 394
Salomon Brothers, 172
Sandage, Scott, 395
Satisfaction (Berns), 398
    “Satisficing,” 42
Savage Money (Gregory), 394
Savage, Jimmy, 394
Savage, Sam, 394
Scenario analysis, 287–289
Scholes, Myron, 255, 329
Seabright, Paul, 394
SEC. See Securities and Exchange
    Commission (SEC)
Secret history of Wall Street:
    1654-1982 period, 57–69
    1983-1987 period, 155–176
Secret history of Wall Street (continued)
1993-2007 period, 345–368
Securities and Exchange Commission (SEC), 94, 97
Securitization, 349, 361–362
Seven principles of risk management:
I: risk duality, 32–33
II: valuable boundary, 33–35
III: risk ignition, 35–38
IV: money, 38–45
V: evolution, 45–48
VI: superposition, 48–49
VII: game theory, 49–55
Sharpe ratio, 81, 83, 91, 92, 174–176
Shiller, Robert, 204, 396
Smile and skew option, 256–257
Soros, George, 52
Sports betting/bettors, 63–66, 219–220
Spread trade, 183, 293–294
Squam Lake Report, The (French, et. al.), 399
Statistical arbitrage, 171
Statistical Decision Functions (Wald), 394
Statistical games, 324–329
Statistical reasoning, basic principles, 342–343
Statistics, history of, 60
Stigler, Steven, 60, 394
Still Life with a Bridle (Herbert), 399
Stock market crash:
Monday, October 19, 1987, 33, 177, 255, 256, 258, 262, 264
Stoller, Martin, 239
Stoller, Phil, 95
Stone Age Economics (Sahlins), 394
Story of money:
1776, continental dollars, 145–147
Andrew Dexter, 147–149
generally, 125–126
government and paper, 138–143
paleonomics, 128–131
paper vs. metal, 142–145
property, exchange and, 126–128
risk, 135–138
transition, 131–134
what money does, 134–135
Strange Days Indeed (Wheen), 399
Stress tests, 283–287
Sull, Donald, 398
Superposition, 48–49
Tail risk—extreme events, 268
Tale of High-Flying Speculation and America’s First Banking Collapse, A (Kamensky), 395
Taleb, Nassim, 32, 37, 393
Tett, Gillian, 399
Thaler, Richard, 126
13 Bankers (Johnson), 395
Thirty Years War, 113
Theory of Blackjack, The (Griffin), 395
Thorp, Edward, 67, 86, 255, 329
To Engineer Is Human (Petroski), 398
“Tolling” swap, 184
Trading from Your Gut (Faith), 297
Trading risk, 217–218
Transaction taxes, 146
Treasury bills/bonds, 170, 171
Trust in Numbers (Porter), 397
Tukey, John, 51, 394
Tulips/tulipomania, 106–116
Unspeakable truths:
good stuff beyond VaR limit, 306–309
parametric, 273–276
risk managers create risk, 309–312
risk managers should make sure firms fail, 299–305

*Upside of Turbulence, The* (Sull), 398

*Useless Arithmetic* (Pilkey), 398

Utility theory:
- change of numeraire and, 42–43
- decision maker identity and, 43
- declining marginal utility and, 41
- extensions, 41–42
- utility maximization, 42

Valuable boundary, 33–35

Value at risk (VaR). *See also* Historical simulation VaR
- back-testing, 230, 233, 271, 275, 342
- beyond profit and loss, 232–234
- birth of, 267, 349
- computing, 271–276
- defined operationally, 33
- illustration, 253–254
- inside boundary, 270, 296
- middle office, 227–228, 230, 232
- not measure of risk, 269
- as orthodox method, 214
- outside boundary, 40–45, 270, 296, 298
- parametric, 273–276
- risk management and, 33–35
- scaling factor, 275, 276
- validation and, 247–249
- “VaR breaks,” 33, 268, 269

Value investors, 195

VaR. *See Value at risk (VaR)*

Vega, 332

Vince, Ralph, 396

Virtual systems, experiments and, 243–244

VIX. *See Chicago Board Options Exchange Volatility Index (VIX)*

Volatility:
- heteroskedasticity, 259–261
- homoskedasticity, 259
- implied, 331–332
- local and stochastic, 257

Volcker, Paul, 368

Wald, Abraham, 394

Waste, 238–241

Wealth, Sharpe ratios and, 174–176

Weatherstone, Dennis, 269

Wheen, Francis, 399

Williams, Jeffrey, 297

Wilmott, Paul 396

Yago, Glenn, 396