

Contents

Preface	xi
About the Authors	xvi
Acknowledgments	xvii
CHAPTER 1	
Introduction	1
Optimization; Simulation; Outline of Topics	
PART ONE	
Fundamental Concepts	
CHAPTER 2	
Important Finance Concepts	11
Basic Theory of Interest; Asset Classes; Basic Trading Terminology; Calculating Rate of Return; Valuation; Important Concepts in Fixed Income; Summary; Notes	
CHAPTER 3	
Random Variables, Probability Distributions, and Important Statistical Concepts	51
What is a Probability Distribution?; Bernoulli Probability Distribution and Probability Mass Functions; Binomial Probability Distribution and Discrete Distributions; Normal Distribution and Probability Density Functions; Concept of Cumulative Probability; Describing Distributions; Brief Overview of Some Important Probability Distributions; Dependence Between Two Random Variables: Covariance and Correlation; Sums of Random Variables; Joint Probability Distributions and Conditional Probability; From Probability Theory to Statistical Measurement: Probability Distributions and Sampling; Summary; Software Hints; Notes	

CHAPTER 4	
Simulation Modeling	101
Monte Carlo Simulation: A Simple Example; Why Use Simulation?; Important Questions in Simulation Modeling; Random Number Generation; Summary; Software Hints; Notes	
CHAPTER 5	
Optimization Modeling	143
Optimization Formulations; Important Types of Optimization Problems; Optimization Problem Formulation Examples; Optimization Algorithms; Optimization Duality; Multistage Optimization; Optimization Software; Summary; Software Hints; Notes	
CHAPTER 6	
Optimization under Uncertainty	211
Dynamic Programming; Stochastic Programming; Robust Optimization; Summary; Notes	
PART TWO	
Portfolio Optimization and Risk Measures	
CHAPTER 7	
Asset Diversification and Efficient Frontiers	245
The Case for Diversification; The Classical Mean-Variance Optimization Framework; Efficient Frontiers; Alternative Formulations of the Classical Mean-Variance Optimization Problem; The Capital Market Line; Expected Utility Theory; Summary; Software Hints; Notes	
CHAPTER 8	
Advances in the Theory of Portfolio Risk Measures	277
Classes of Risk Measures; Value-At-Risk; Conditional Value-At-Risk and the Concept of Coherent Risk Measures; Summary; Software Hints; Notes	
CHAPTER 9	
Equity Portfolio Selection in Practice	321
The Investment Process; Portfolio Constraints Commonly Used in Practice; Benchmark Exposure and Tracking Error Minimization; Incorporating	

Transaction Costs; Incorporating Taxes; Multiaccount Optimization; Robust Parameter Estimation; Portfolio Resampling; Robust Portfolio Optimization; Summary; Software Hints; Notes

CHAPTER 10

Fixed Income Portfolio Management in Practice

373

Measuring Bond Portfolio Risk; The Spectrum of Bond Portfolio Management Strategies; Liability-Driven Strategies; Summary; Notes

PART THREE

Asset Pricing Models

CHAPTER 11

Factor Models

401

The Capital Asset Pricing Model; The Arbitrage Pricing Theory; Building Multifactor Models in Practice; Applications of Factor Models in Portfolio Management; Summary; Software Hints; Notes

CHAPTER 12

Modeling Asset Price Dynamics

421

Binomial Trees; Arithmetic Random Walks; Geometric Random Walks; Mean Reversion; Advanced Random Walk Models; Stochastic Processes; Summary; Software Hints; Notes

PART FOUR

Derivative Pricing and Use

CHAPTER 13

Introduction to Derivatives

477

Basic Types of Derivatives; Important Concepts for Derivative Pricing and Use; Pricing Forwards and Futures; Pricing Options; Pricing Swaps; Summary; Software Hints; Notes

CHAPTER 14

Pricing Derivatives by Simulation

531

Computing Option Prices with Crude Monte Carlo Simulation; Variance Reduction Techniques;

Quasirandom Number Sequences; More Simulation
Application Examples; Summary; Software Hints; Notes

CHAPTER 15

Structuring and Pricing Residential Mortgage-Backed Securities 587

Types of Asset-Backed Securities; Mortgage-Backed Securities: Important Terminology; Types of RMBS Structures; Pricing RMBS by Simulation; Using Simulation to Estimate Sensitivity of RMBS Prices to Different Factors; Structuring RMBS Deals Using Dynamic Programming; Summary; Notes

CHAPTER 16

Using Derivatives in Portfolio Management 627

Using Derivatives in Equity Portfolio Management; Using Derivatives in Bond Portfolio Management; Using Futures to Implement an Asset Allocation Decision; Measuring Portfolio Risk When the Portfolio Contains Derivatives; Summary; Notes

PART FIVE

Capital Budgeting Decisions

CHAPTER 17

Capital Budgeting under Uncertainty 653

Classifying Investment Projects; Investment Decisions and Wealth Maximization; Evaluating Project Risk; Case Study; Managing Portfolios of Projects; Summary; Software Hints; Notes

CHAPTER 18

Real Options 707

Types of Real Options; Real Options and Financial Options; New View of NPV; Option to Expand; Option to Abandon; More Real Options Examples; Estimation of Inputs for Real Option Valuation Models; Summary; Software Hints; Notes

References 733

Index 743