

Contents

Preface	vii
List of Code Examples.....	xix
1 Linear and Quadratic Programming.....	1
1.1 Linear Programming: Testing for Arbitrage.....	1
1.2 Quadratic Programming: Balancing Risk and Return	6
1.3 Dual Variables and the Impact of Constraints.....	17
1.4 Analysis of the Efficient Frontier	24
Exercises.....	30
Endnotes	32
2 General Optimization with SIMPLE	35
2.1 Indexing Parameters and Variables	35
2.2 Function Optimization.....	45
2.3 Maximum Likelihood Optimization.....	50
2.4 Utility Optimization	54
2.5 Multistage Stochastic Programming.....	61
2.6 Optimization within S-PLUS	69
Exercises.....	79
Endnotes	80
3 Advanced Issues in Mean-Variance Optimization	81
3.1 Nonstandard Implementations.....	81
3.2 Portfolio Construction and Mixed-Integer Programming.....	90
3.3 Transaction Costs	98
Exercises.....	106
Endnotes	108
4 Resampling and Portfolio Choice.....	109

4.1	Portfolio Resampling.....	109
4.2	Resampling Long-Only Portfolios	114
4.3	Introduction of a Special Lottery Ticket	115
4.4	Distribution of Portfolio Weights.....	120
4.5	Theoretical Deficiencies of Portfolio Construction via Resampling	126
4.6	Bootstrap Estimation of Error in Risk-Return Ratios.....	129
	Exercises.....	136
	Endnotes	139
5	Scenario Optimization: Addressing Non-normality.....	141
5.1	Scenario Optimization.....	141
5.2	Mean Absolute Deviation.....	153
5.3	Semi-variance and Generalized Semi-variance Optimization	158
5.4	Probability-Based Risk/Return Measures.....	164
5.5	Minimum Regret	170
5.6	Conditional Value-at-Risk.....	174
5.7	CDO Valuation using Scenario Optimization	189
	Exercises.....	193
	Endnotes	194
6	Robust Statistical Methods for Portfolio Construction.....	195
6.1	Outliers and Non-normal Returns	195
6.2	Robust Statistics versus Classical Statistics	200
6.3	Robust Estimates of Mean Returns	202
6.4	Robust Estimates of Volatility	209
6.5	Robust Betas.....	218
6.6	Robust Correlations and Covariances	221
6.7	Robust Distances for Determining Normal Times versus Hectic Times	226
6.8	Robust Covariances and Distances with Different Return Histories	233
6.9	Robust Portfolio Optimization	238
6.10	Conditional Value-at-Risk Frontiers: Classical and Robust	261
6.11	Influence Functions for Portfolios.....	276
	Exercises.....	294
	Endnotes	297
7	Bayes Methods	299
7.1	The Bayesian Modeling Paradigm	299
7.2	Bayes Models for the Mean and Volatility of Returns	303
7.3	Bayes Linear Regression Models	346
7.4	Black-Litterman Models	359
7.5	Bayes-Stein Estimators of Mean Returns	375

7.6 Appendix 7A: Inverse Chi-Squared Distributions.....	380
7.7 Appendix 7B: Posterior Distributions for Normal Likelihood Conjugate Priors.....	384
7.8 Appendix 7C: Derivation of the Posterior for Jorion's Empirical Bayes Estimate	384
Exercises.....	387
Endnotes	389
Bibliography.....	393
Index	401