

INDEX

- actuaries, 38, 148
- adjusted trading range, 134–36
- AIG (American International Group), 75
- Altman, Edward I., 95
- American International Group (AIG), 75
- approximations: binomial and normal
 - approximations, 110–11; fat-tailed
 - approximations, 111–13; Gaussian
 - approximations, 111, 225–26
- ARCH (Autoregressive Conditional
 - Heteroskedasticity), 138–39
- asset valuation, 35, 174
- assignats*, 46
- Autoregressive Conditional
 - Heteroskedasticity (ARCH), 138–39
- bad money, 22–24
- banking: boom and bust and, 57–60;
 - breakdown and regulation in, 62–64;
 - contingent reserves and, 74–75; credit
 - orbits and, 60–62, 61f, 190–92; credit
 - rating and, 214–15; debt-fueled growth
 - and, 194–95; duration mismatch and,
 - 56–57; economic cycles and, 188; fiscal
 - response per unit debt, 192–94;
 - introduction to, 53–54; Lotka-Volterra
 - model and, 188–89; narrow banking,
 - 55–56; regulating, 150–51; rise and
 - history of, 54–55; static equilibria
 - and, 189
- bank runs, 21, 62, 64
- bargains, 167–68
- barter, 15
- Basel Committee on Banking
 - Supervision, 63
- Basel I, 2, 63, 74–75, 150–51
- Basel II: banking regulation and, 63–64,
 - 150–51; capital requirements
 - estimation equation and, 195;
 - contingent reserves and, 75; credit
 - rating and, 98, 114, 115
- Basel III, 78
- Bayes, Rev. Thomas, 10
- Bayes' Rule, 10, 71, 85, 163–64, 203–4

- behavioral finance, xii, 3, 140–41, 154
- beliefs: beta-distributed beliefs, 197;
 - Brownian beliefs, 254–55; gamma-distributed beliefs, 198–202; mean beliefs, 196–97; rational beliefs, 162; stationary distribution of, 259–60
- BET (Binomial Expansion Technique), 110–11, 225
- beta-binomial distribution, 228–29, 230–31
- beta distributions, 72, 197, 228–29
- bimetallism, 16–17, 22
- binomial distribution, 110–11, 224, 228–29
- Binomial Expansion Technique (BET), 110–11, 225
- binomial triangles, 222
- Black-Scholes model of options pricing, 116
- Bogoliubov hierarchy, 257
- bonds: bond seigniorage, 42–43, 184;
 - default rates of, 212–13; rates on, 34–35
- boom and bust, 57–60, 63
- Bretton Woods (1944), 23
- Brownian bridge, 135–36, 249–54
- Brownian motion, 161–62, 245–46, 249–50, 254–55
- Brownian range, 248–49
- bubbles, 2, 26, 51–52, 96, 98, 146
- cash seigniorage, 42
- CCRA utility, 170
- Central Limit Theorem, 111, 162–63, 225–26, 252
- chaos theory, 89
- charting, 132–34, 144
- checks, 54
- Churchill, Winston, 145
- command economies, 18–20
- complexity, 195
- Conditional Value at Risk (CVaR), 246
- confidence intervals, 97
- conjugate pairs, 164
- consensus, 101–2, 103
- consol, 41
- constant relative risk aversion utility, 170
- consumption-based pricing, 175–76
- consumption smoothing, 171–72
- contingent reserves, 72–75, 104
- convictions, Bayesian updating of, 204
- copulas, 115–17, 231–33
- CorBin distribution, 111–12, 113, 114, 226–28, 230
- correlation: CorBin distribution, 111; in portfolio risk analysis, 108–10, 224–25
- cost of waiting, 168–69
- Cox-Ingersoll-Ross model, 218
- credit grades, 93–94, 97
- credit migration, 99–100
- credit orbits, 60–62, 61f, 190–92
- credit rating: conclusions on, 151–52;
 - consensus and, 101–2; corporate bond default rates and, 212–13; credit grades and, 93–94; diffusions and, 216–17; EMAs with drift and, 218–19; factor analysis of default risk and, 95–96, 213; gamma distributions as long-term equilibria and, 217–18; grading uncertainty and, 97–99; impact of, on lending, 214–15; introduction to, 92–93; Ising-type models and, 219–20; migration of, 99–100, 216; parameter fitting and, 218; pricing credit risk and, 215–16; stickiness, 102–4; unreliability at extremes of, 213–14
- credit risk, 54–55, 215–16
- CreditRisk +, 92, 112
- credit score, 95
- credit spiral, 193–94
- Credit Suisse First Boston, 112
- crisis, 20–21, 46–48, 57
- “Crunch,” 191–92
- cumulant(s): cumulant expressions, 180–81; cumulant generating functions, 157, 159; cumulant hierarchies, 90, 257; cumulant laws,

- 162–63; defined, 88; updating, 154, 209–10, 255–57
- cumulative probability, 158
- cumulative volatility, 134
- currency inertia, 173
- CVaR (Conditional Value at Risk), 246
- Darwin, Charles, 81
- debt: credit orbits and, 60–62; “debt deflation” cycle, 20; debt-fueled growth, 194–95; *droit de prêt* and, 74; financial crises and, 46–47; fiscal response per unit and, 192–94; historical perspective on, 44–46; introduction to, 40–41; lender faith and, 43–44; perpetual, deferral, 148–50; perpetuities and, 183–85; quasi-sovereign debt, 47; St. Petersburg Paradox and, 185–86; sustainability and, 186–87; in United States, 48; worthless debt, 49–51, 51f, 185–86; worthy debt, 41–42
- decay rate evolution, 87f
- default: fractional evidence of, 66, 70–72; sovereign default, 148–49; time and certainty of, 185–86
- default rates, 94, 95–96, 96f, 212–13
- default risk: alternative formulations for, 201; classic estimation for, 196; for correlated debt portfolios, 112f; credit grades and, 93–94; estimators for, 86f; exchangeable, 221–22; expected, for 100 credits with 2\$ mean risk and 5% correlation, 113f; factor analysis of, 213; with gamma beliefs, 201–2; in portfolio risk analysis, 106–8, 112; versus probability of three defaults in a century, 68f; uncertainty and, 67–73, 97
- de Finetti, Bruno, 10, 108
- de Finetti’s Theorem, 108, 115, 224
- deflation, 20
- demands for money, 17–18, 172
- demonetization, 16–17
- Devlin’s Triangle, 106–7
- differences, distributions of, 220–21
- diffusions, 162, 216–17
- disaster, 181–82
- discounting, 174–75
- distributions: beta-binomial
 - distribution, 228–31; beta distributions, 72, 197, 228–29; binomial distribution, 110–11, 224, 228–29; CorBin distribution, 111–14, 226–28, 230; of differences, 220–21; gamma distributions, 100, 198–202, 207–8, 217–18; gamma-Poisson distribution, 201–2; Gaussian distribution, 159–60, 226; Laplace distribution, 221; NegBin distribution, 112–15, 229–30; normal distribution, 110–11, 159–60; Poisson distribution, 201; Pólya distribution, 201; standard normal distribution, 159–60; stationary distribution, 217, 259–60; *t*-distribution, 122–23, 135, 236–38
- domestic sovereign default, 148–49
- doubts, 81–83, 83f
- droit de prêt*, 74
- duration mismatch, 56–57
- dynamic mixtures of EMAs, 85–86, 87
- ease of resale, 16. *See also* liquidity
- economic cycles, 188
- economic growth: calculating future, 28–30; interpretations of, 32–34; rates on equities and bonds and, 34–35; regime change and, 35–38; technological progress and, 30–32
- Einstein, Albert, 79
- EIS (elasticity of intertemporal substitution), 169
- elasticity of intertemporal substitution, 169
- electricity, 36
- Elizabeth, Queen, 44–45

- EMA (exponential moving average). *See* exponential moving average (EMA)
- emotion, 141
- empirical Value at Risk, 121, 123, 125, 131
- endogenous uncertainty, 165
- entropy, 165
- equilibrium uncertainty, 259–61
- equities, rates on, 34–35
- error correction, 2–3
- Estonia, 19
- euro, 24, 47
- European Central Bank (ECB), 63
- exchangeability, 106–8, 224
- exchangeable default risks, 221–22
- exogenous uncertainty, 162
- expectations, 158, 169
- expected utility, 169, 171, 172, 243
- expertise, in risk analysis, 147–48
- exponential moving average (EMA), 84–86, 129, 207–9, 218–19, 241–42
- fat-tailed approximations, 111–13
- fat tails, in Value at Risk, 121–23
- Federal Reserve, 63
- ferromagnetism, 101
- fiat currency, 15, 166
- filters, 84–86
- finance, learning in, 3–5
- finance theory, for 21st century, 154–55
- financial crisis (2008), 146
- financial risk regulation, 76–77
- Fisher, Irving, 20
- Fisher, Ronald A., 81, 95
- Fokker-Planck equation, 90–91, 217, 257, 259
- foolishness, 141
- forecasting, 89, 90, 125–26, 129–30, 153
- foreign exchange reserves, 24–26, 25f, 174
- fractional evidence of default, 66, 70–72
- France, 16–17, 46
- fundamental theorem of natural selection, 81
- future value: calculating, 29–32; interpretations of economic growth and, 32–34; introduction to, 28–29; rates on equities and bonds and, 34–35; regime change and, 35–38
- FX reserves, 24–26, 25f, 174
- game theory, 10
- gamma distributions, 100, 198–202, 207–8, 217–18
- gamma-Poisson distribution, 152, 201–2
- gamma-Poisson mixture, 114, 230
- GARCH (Generalized Autoregressive Conditional Heteroskedasticity) model, 139–40, 144
- Gaussian approximations, 111, 225–26
- Gaussian buffers, 114, 115f
- Gaussian copula, 116
- Gaussian distribution, 159–60, 226
- GDP: and government debt for OECD members, 43–44, 45f; historical growth of, 31, 32f; U.S. federal debt and, 43, 44f; worthy debt and, 42
- Generalized ARCH model, 139–40, 144
- generating functions: Bayesian updating of, 209; cumulant generating functions, 157, 159; moment-generating functions, 158, 164, 224, 227, 230, 256
- gold standard, 16–17, 19, 22–23
- good money, 22–24
- Gorbachev, Mikhail, 19
- Great Britain: boom and bust in, 58–59; gold standard and, 16, 23; history of debt in, 44–45; lender faith and, 43; perpetual debt deferral and, 149; perpetuity in, 41
- Greenspan, Alan, 63
- Greenspan put, 63
- Gresham's Law, 22, 63
- growth, debt-fueled, 194–95
- habit, 177–78, 179
- Hardy, Godfrey, 81

- Hardy-Weinberg Principle, 81
- Hausdorff moment theorem, 224
- herding, 5, 33
- higher moments, 158, 203
- high/low/open/close (HLOC) data, 136
- hive, wisdom of, 88
- HLOC data, 136
- hoarding, 18, 20
- hyperplanes, 246
- “iceberg risk,” 179
- Iceland, 57
- Iceland stock index (OMX), 57, 58f
- immediacy, 33
- imprecision, 123–25
- independence, 161–63
- infinite geometric series, 172–73
- innovation, 30–32, 36
- instability, 181–82
- insurance risk, 36–38
- irrational exuberance, 141
- Ising-type models, 101, 102, 154, 219–20
- juros*, 46
- Kelly criterion, 129
- Keynes, John Maynard, 5, 9, 17–18
- Knight, Frank, 8–9
- knowledge, 66–67
- kurtosis, 121–22, 234, 235–36, 238–39
- Laplace distribution, 221
- learning: in finance, 3–5; risk in, 1–3, 145–46; study and development of, 6
- Lehman Brothers, 55, 75
- lender faith, 43–44
- leverage ratio, 55
- Li, David X., 116
- liquidity: banking and, 54, 56, 150; “liquidity trap,” 20–21; money as, 14–17, 166–67; as perpetual put, 17–18; precautionary and speculative demands and, 172
- living death, 76–77
- logarithmic change, 175
- logistic factor analysis, 95–96, 213
- logistic function, 211
- logistic regression, 213
- log odds ratio, 210–12
- Lorenz, Edward N., 89
- Lotka-Volterra equation, 61
- Lotka-Volterra model, 188–89
- Louis XVI, 46
- Madoff scandal, 147
- Mahserg’s Law, 22–24, 35, 173
- Mammon, 40
- Mark, Karl, 188
- market bubbles, 2, 26, 51–52, 96, 98, 146
- market knowledge, 66–67
- markets: controlling, 146–47; error correction and, 3; inferences in, 5; market learning, 6; prediction markets, 247; studying, 89; volatility of, 182
- Markopolos, Harry, 147
- Markov switching, 181, 205, 206f
- Marx, Karl, 18, 90
- May, Robert M., 100
- mean, and correlation in portfolio risk analysis, 108–10
- mean beliefs, 196–97
- mean field model, 219
- mean squared error (MSE), 123, 233–34
- Mexico, 67
- migration, of credit ratings, 99–100, 216
- modular updating, in regime change, 204–5
- moments: Hausdorff moment theorem, 224; higher moments, 158, 203; moment-closure problem, 90–91; moment-generating functions, 158, 164, 209, 224, 227, 230, 256; portfolio moments, 223

- money: command economies and, 18–20; consumption smoothing and, 171–72; in crisis, 20–21; currency inertia, 173; elasticity of intertemporal substitution and, 169; expected utility and, 169; fiat currency, 166; foreign exchange reserves and, 24–26, 25f, 174; introduction to, 14; as liquidity, 14–17; and liquidity as put, 17–18, 166–67; Mahserg’s Law and, 22–24; opportunity cost and, 168–69; precautionary and speculative demands and, 172; relative risk aversion and, 170–71; search for bargains, 167–68
- Moody’s, 92, 93–94, 94f
- narrow banking, 55–56
- natural selection, 81
- NegBin (negative binomial distribution), 112–13, 114–15, 229–30
- normal distribution, 110–11, 159–60
- observations, overlapping, 253
- OECD. *See* Organisation for Economic Cooperation and Development (OECD)
- opportunity cost, 16, 168–69
- options, perpetual, 166–67
- Organisation for Economic Cooperation and Development (OECD), 43–44, 45f
- Orphanides, Athanios, 20
- orthodox finance, 3
- Osband triangle, 106–7, 108, 222–23, 224
- overlapping observations, 253
- Pandora’s Equation, 89, 132, 154, 257
- Pandora’s risk, 1, 2
- parameter fitting, 218
- Parkinson, Michael, 248
- Pascal’s triangle, 107, 221–22
- payment systems, 54–55
- percentage change, 175
- percentile estimators, 240–41
- perpetual debt deferral, 148–50
- perpetual options, 166–67
- perpetuity/perpetuities, 41–42, 183–85
- peso, 67
- PIIGS (Portugal, Italy, Ireland, Greece, and Spain), 47, 59, 63, 74, 78, 98
- Planck, Max, 154
- Poisson distribution, 201
- Poisson jumps, 197–98, 229
- Pólya distribution, 201
- portfolio insurance, 116
- portfolio moments, 223
- portfolio risk analysis: beta-binomial distribution and, 228–29; binomial and normal approximations in, 110–11; Binomial Expansion Technique and, 225; copulas in, 115–17, 231–33; CorBin distribution and, 226–28; correlation in, 108–10, 224–25; exchangeability in, 106–8, 221–22, 224; false confidence in, 113–15; fat-tailed approximations in, 111–13; Gaussian approximations and, 225–26; introduction to, 105–6; mixed binomial tail risks and, 230–31; NegBin and, 229–30; Osband triangles and, 222–23; portfolio moments and, 223
- Portugal, Italy, Ireland, Greece, and Spain (PIIGS). *See* Portugal, Italy, Ireland, Greece, and Spain (PIIGS)
- precautionary demand for money, 18, 172
- prediction markets, 247
- price charts, studying, 132–34
- price offset, 32–33
- pricing, consumption-based, 175–76
- probability: Bayes’ Rule and, 163–64; conditional, 161–62; cumulants and, 159; default risk and, 68f; de Finetti’s Theorem and, 108; distributions, 157–58; expectations and, 158; Gaussian distribution and, 159–60; higher moments and, 158; log odds

- ratio versus, 211f; multivariate, 161;
- rational beliefs and, 162; uncertainty and, 10, 164–65
- productivity boosts, 36
- put(s): failed, 18–20; liquidity as, 17–18, 166–67
- Pygmalion, 145
- quantum theory, 154
- quasi-sovereign debt, 47
- rational beliefs, 162
- rational learning, 140–42
- Rayleigh’s Law, 153
- recursive utility, 178–79
- “reflexivity,” 11
- regime change: Bayesian updating and, 203–4, 209; differential terminology and, 203; exponential moving average and, 207–9; financial selection and, 81; incorporating, 83–86; inferences from markets in, 86–88; introduction to, 79–80; limited predictability in, 210; log odds ratio and, 210–12; modular updating and, 204–5; regime switching and, 205–8; tiny doubts and, 81–83; unpredictability and, 88–90; wealth and, 35–38, 37f
- regulation: banking, 62–64, 150–51; financial risk regulation, 76–77; risk regulation, 76–77
- regulatory arbitrage, 75
- relative risk aversion, 170–71, 176–77
- resale, ease of, 16. *See also* liquidity
- Ricardian equivalence theorem on public debt, 184
- risk: adjusted trading range and, 134–36; Brownian bridge and, 249–55; Brownian range and, 248–49; charting and, 132–34; conclusions on resizing, 143–44; cumulant updating and, 255–57; equilibrium uncertainty and, 259–61; expertise in, analysis, 147–48; financial crises and, 146–47; introduction to resizing, 132; learning, 145–46; rational learning and, 140–42; relative risk aversion, 170–71; risk-adjusted investment, 142–43; S&P 500 Index and, 136–38; turbulence and, 257–59; versus uncertainty, 8–10; volatility and, 138–40, 261–62
- risk accounts, 77
- risk-free lending, 43
- risk-free rate, 176–77, 179
- RiskMetrics, 125
- risk-pertise, 147–48
- risk premium, 34–35, 41–42, 169, 176–77, 179
- risk regulation, 76–77
- robust estimators, 239–40
- RRA (relative risk aversion), 170, 176–77
- ruble, 19
- S&P 500 Index, 126–27, 130, 136–38, 140–41, 253–54
- safety: beta-distributed beliefs and, 197; complexity and, 195; contingent reserves and, 72–75; default risk estimation and, 196–97, 201; default risks with gamma beliefs and, 201–2; default uncertainty and, 68–70; gamma-distributed beliefs and, 198–200; introduction to, 66; market knowledge and, 66–67; Poisson jumps and, 197–98; rational updating and, 71–72; risk regulation and, 76–77; tail risks and, 202–3
- SAMURAI (Self-Adjusting Mixtures Using Recursive Artificial Intelligence), 129, 242–44
- Saveland, 59–60
- scoring rules, 129–30, 246–47
- SEC (Securities and Exchange Commission), 63
- Securities and Exchange Commission (SEC), 63

- seigniorage, 42–43, 184
- Self-Adjusting Mixtures Using Recursive Artificial Intelligence (SAMURAI), 129, 242–44
- sexual reproduction, 81
- Sharpe ratio, 142, 143, 182
- Shiller, Robert J., 140–41
- sigmoid function, 211
- silver standard, 16–17
- simple moving average (SMA), 208
- Sismondi, J-C-L. Simonde de, 188
- SMA (simple moving average), 208
- social experience, 178
- Soros, George, 11
- sovereign default, 70, 148–49
- Soviet Union, 18–20, 55, 66–68
- Spain, 45. *See also* PIIGS (Portugal, Italy, Ireland, Greece, and Spain)
- speculative demand for money, 18, 172
- Spendland, 59–60
- SRE (standard relative error), 123–24, 233–34, 241
- standard deviation estimator, 234–35, 241–42
- standardization: monetary, 23–24; of random variables, 158; of Student's t , 237–38
- standard normal distribution, 159–60
- standard relative error (SRE), 123–24, 233–34, 241
- standard Value at Risk, 119, 125, 126, 128, 130
- static equilibria, 189
- stationary distribution, 217
- St. Petersburg Paradox, 186
- Student's t , 122–23, 135, 236–38
- “Surge,” 191–92
- tail risks, 179–80, 202–3, 230–31, 233
- Taleb, Nassim, 12
- tax collection, 44
- t -distribution, 122–23, 135, 236–38
- technological progress, 30–32, 36
- time, 161–62, 185–86
- tiny doubts, 81–83, 83f
- Tolstoy, Leo, 70
- Toronto Stock Exchange (TSE), 37
- transactions demand for money, 17
- Troubled Asset Relief Program, 77
- turbulence, 257–58
- Twain, Mark, 2, 10
- uncertainty: benefits of, 2; credit ratings and, 97–99, 104; default uncertainty, 68–70; entropy and, 164–65; exogenous and endogenous, 162; managing, 132; probability measures and, 164; quantification of, 10–12; regime change and, 90; versus risk, 8–10, 163
- United States: boom and bust in, 58–59; budgetary outlook for, 48f; corporate bond default rates in, 95–96, 96f, 212–13; corporate default rates in, 94f; debt of, 48; federal debt and GDP of, 43, 44f; gold standard and, 16–17; perpetual debt deferral and, 149; U.S. dollar, 20, 21, 22f, 23–24
- unpredictability, 88–90
- updating, 81–82
- U.S. dollar, 20, 21, 22f, 23–24
- usefulness, 16. *See also* utility
- USSR, 18–20, 55, 66–68
- utility: CCRA utility, 170; expected utility, 169, 171, 172, 243; recursive utility, 178–79
- Value at Risk (VaR): Brownian motion and, 245–46; conclusions on, 152–53; EMAs of standard deviation and, 241–42; fat tails in, 121–23; imprecision and, 123–25; introduction to, 119–21; kurtosis and, 234, 235–36, 238–39; percentile estimators and, 240–41; robust estimators and, 239–40; S&P 500 Index and, 125–28; SAMURAI updating and, 242–44; scoring rules

- in, 129–30, 246–47; standard deviation estimator and, 234–35; standard relative error and, 233–34; Student's t and, 236–38; tail risks in, 233
- variance, Bayesian updating of, 203–4
- volatility: cumulative volatility, 134;
 - estimating, 128, 251, 252; excess, 143–44; of markets, 182; rational learning and, 140–42; risk-adjusted investment and, 142–43; for simulated prices, 261–62; in two-regime example, 258–59; volatility of, 137–40
- waiting costs, 168–69
- war, 43
- wealth: asset valuation and, 174;
 - calculating future economic growth and, 29–32; consumption-based pricing and, 175–76; cumulant expressions and, 180–81; discounting, 174–75; duration mismatch and, 56; habit and, 177–78; instability and, 181–82; interpretations of economic growth and, 32–34; introduction to, 28–29; logarithmic change and, 175; market volatility and, 182; rates on equities and bonds and, 34–35; recursive utility and, 178–79; regime change and, 35–38; risk rate and, 176–77; tail risks and, 179–80
- weather, predicting, 89
- Weinberg, Wilhelm, 81
- wisdom of the hive, 88
- worthless debt, 49–51, 51f, 185–86
- worthy debt, 41–42

- Yang Hui's triangle, 107
- Yoshizawa, Yuri, 94

