11-standard-deviation surprise, 224 analysis simplification, 164-165 12-standard-deviation surprise, 79-84 antitrust litigation, 159 Asch, Solomon, 15 ABX index, 88-91 asymmetric information. See information accuracy, 63-68 asymmetry accurate updating, 131-136 asymmetric outcomes, 44-48 Advance America: Black Swan, 108; avalanche prediction, 10-11 FDIC, 107; information strategy, 106-109; regulatory risk, 106-109; Bagehot, Walter, 17 stock price 2005-2006, 108-109 Bank for International Settlements, "affinity" credit cards, 222 225-229 agenda control, 148-149 Bank of America, 77-78, 223, algorithmic capital standards failure, 230-231 225-229 bank panics, 19-20 Basel I, 225 algorithms, 213-214, 216-221 American Express: causal relationships, Basel II: Bank for International 171-175; collateral damage, 181; Settlements, 225–226; capital ratios, critical issues, 170-173; indexed 226; cost of implementing in Europe, stock price performance 2007-2008, 227; FDIC, 228; judgment, 225-229; macroprudential orientation, 227-228; 176; information asymmetry, 139, 152-153; legal risk, 180-184; Peltzman, Sam, 228; "The Peltzman lending, 171; litigation risk scenarios, effect," 228; Seidman, Bill, 228 182; mapping, 169-171; Marcus v. Bayesian networks, 39 American Express, 181, 184; Bernanke, Ben, 19-20 MasterCard, 183-184; Monte Carlo biased information sources, 103-104 modeling, 180-184; no-surcharge Black, Fischer, 18 Black Hawk Down, 101 rules, 181; outcome, 175-177; output Black Swan: Advance America, 108: variable, 172; premium customer base, 170; pricing power, 170; risk Countrywide, 72; definition, ix, x; factors, 182-183; spending, 171; Discover Financial Services, 136; stock price 1999–2000, 36; stock Fannie Mae, 31; information overload, price 1999-2002, 52; stock price 108; judgment, 234-235; mapping, 2005-2006, 184 167; MasterCard, 167; MBNA, 224; American Meteorological Society Monte Carlo modeling, 179; (AMS), 9 Providian, 33–39, 51; Sallie Mae, AMS. See American Meteorological 207-212; subprime mortgage loss, Society analysis, 64-66 Black-Scholes option pricing model, 18

boiling frog syndrome. *See* change blindness
Browne, Chris, 216–217
brute-force approach, 103
bubbles, classic theory, 12
Buffett, Warren, 216–218
"The Buffett System," 216–218
bureaucratic inertia, 105
Burton, Robert, 62
business model risk, 195–196
butterfly effect, 8–10

calibration, 23–25 call option, 60-61, 183-184 Capital One Financial Corporation: information asymmetry, 36, 52, 139 - 140capital ratios, 226 capital-market crash of 2007-2008, 233-234 catalyst identification, 135-136 catalysts, 25–27 causal relationships: Fannie Mae, 195; judgment, 211, 233; mapping, 171–175; Monte Carlo modeling, 195; Sallie Mae, 211, 233 causation, 192-194 causative significance of management incentives, 168 causative variables, 191-192 CDOs. See collateralized debt obligations CDS. See credit default swaps change blindness, 111, 118-122 Chicago Board Options Volatility Index (VIX), 122–123 CIT Group: CDS, 57; confidence, 56-59; decision-making, real-time, 111-115, 128; GE Capital, 112; Kozlowski, Dennis, 112; Newcourt, 111–112; probability tree, 114;

real-time updating strategy, 128; risk

factors, 113; SAMs, 115; stock price

2002-2003, 115; stock price

2007–2008, 59; Tyco, 112

class action suit, 159-160 cognitive dissonance: computational roots, 116-117; conflicting data, 145–146; Countrywide, 143; decision-making, real-time, 111, 116-118, 130-131; definition, 116; Freddie Mac, 146-148, 147; Gilad, Ben, 143; Golden West, 144; industry dissonance, 143; information asymmetry, 142-154, 146-148; limited choices, 118; mapping, 163; Mayo, Michael, 144-145; option ARMs, 144; rationality of, 144; self-image, 117-118; sources, 117-118; Steel, Robert, 144-145; Wachovia Bancorp, 144-145 collateral damage, 181 collateralized debt obligations (CDOs), 13, 185-190 collective action, 234 collective behavior, 11-13 combinatorial explosion, 163–164 communication overload, 104-105 competition, 64-66, 160-161 competitors, 214-216 complex modeling, 68–72. See also confidence complexity theory, 98 computation, 97–98 computational roots, 116–117 conditional probabilities, 126 confidence: analysis accuracy, 64-66; Bank of America, 77–78; Burton, Robert, 62; call option, 60-61; CDS, 57; CIT Group, 56–59; competition and, 64–66; complex modeling, 68-84; contributory factors, 63; Countrywide, 72-78; decision accuracy, 66-68; decision-making accuracy, 63; development (over time), 64-66; emotional, 62-64; Gladwell, Malcolm, 63; Golden West stock volatility, 76; interval, 61; intuition, 62-63; judgment, 213; Kahneman,

Daniel, 68-70; Klein, Gary, 62-63; loan-level loss models, 80-81; (in the) markets, 59-61; model-related overconfidence, 72-79; New Century Financial stock volatility, 76; options market, 60-61; overconfidence in action, 65; overconfidence vs. underconfidence, 59-60; properly specified loss models, 82–83; put option, 60; representativeness heuristic, 68-72; representativeness heuristic probability tree, 71; share of origination market, 74; short strangle, 60-61; standard deviation, 79-80; stock volatility, 76; subprime mortgage collapse, 76-84; Tversky, Amos, 68-70; underconfidence in action, 66; Washington Mutual stock volatility, 76; Wells Fargo stock volatility, 76. See also complex modeling conflicting data, 145-146 Congressional Budget Office, 205 consequences, 185-186 conviction levels vs. new data, 121 - 122correlation: causation, 192-194; causative variables, 191-192; CDO, 1975–2004, 189; home prices

185–190; CDO-squareds, 186–188; consequences, 185–186; home prices 1975–2004, 189; home prices 1975–2008, 190; in housing markets, 186–188; LTCM hedge fund, 185–186; misestimating, 185–186; Monte Carlo modeling, 185–194; normalized distributions, 189; principal components analysis, 191–192; probability trees, 48–49; standard deviation, 190; trading, 186–188; volatility, 193
Countrywide: Bank of America, 77–78; Black Swan, 72; confidence, 72–78;

Fannie Mae, 6; information

asymmetry, 143; share of origination

market, 74; stock price 1999–2006, 74; stock price 2006–2008, 78; stock volatility, 76 credit card companies, 33–34, 131–136 credit default swaps (CDS), 57, 229–230 credit risk, 204 critical issues: Fannie Mae, 194–195; information overload, 100–102; information strategy, 100–102; judgment, 211, 213; mapping, 161, 170–173; mapping to stock price, 165; Monte Carlo modeling, 194–195; probability trees, 40; Providian, 40; Sallie Mae, 211

data mining, 103 decision tree for new information, 127 decision-making, real-time: accurate updating, 131-136; boiling frog syndrome, 111, 118-122; catalyst identification, 135-136; change blindness, 111, 118–122; CIT Group, 111-115, 128; cognitive dissonance, 111, 116-118, 130-131; computational roots, 116-117; conditional probabilities, 126; conviction levels vs. new data, 121-122; credit card industry, 131-136; decision tree for new information, 127; definition, 116; diagnostic power of new information, 111, 125; Discover Financial Services, 131–136; Discover Financial Services stock price 2007-2008, 134; extreme volatility, 123-125; Fannie Mae, 119-120; Freddie Mac, 120; GE Capital, 112; GSEs, 119–120; Kozlowski, Dennis, 112; limited choices, 118; long-term hypotheses, 123; Newcourt, 111–112; political risk, 119–120; practical techniques, 130-131; probability tree, CIT Group, 114; probability tree, Discover Financial Services, 133; Providian, 126-128; real-time updating strategy,

decision-making, real-time (continued) 125-129; regulatory risk, 119-120; revised probability, 126-128; risk factors, 113; SAMs, 115, 129; selfimage, 117-118; the "sell decision," 131; sources, 117–118; stubbornness, 122-123; traditional approaches, 124-125; Tyco, 112; VIX, 122-123; volatility, 124-125; wishy-washiness, 122 - 123decision-making accuracy, 63 decision-making cycle, 215 derivatives, 29, 196 diagnostic power of new information, 111, 125 Discover Financial Services, 131–136, 158, 223; Black Swan, 136 discrimination, 23-24, 43 Dodd, David, ix "dragon risk," 214

emotional confidence, 62-64 entropy, 97 estimated volatility, 201 expected value, 38 expert knowledge, lack of, 105 extreme distributions, 10-11 extreme volatility: bank panics, 19-20; Bernanke, Ben, 19-20; bubbles, classic theory, 12; CDOs, 13; collective behavior, 11-13; decision-making, real-time, 123-125; feedback effects, 20-21; financial fragility hypothesis, 19; Great Depression, 19-20; leverage, 21; markets and fundamentals, 18-22; Minsky, Hyman, 19; nonlinear fundamentals, 7; reflexivity, 19; Shiller, Robert J., 11-12, 15; Soros, George, 19; South Sea Company, 12; wealth effect, 19

earthquake prediction, 10-11

The Economist, 17

Fannie Mae: Black Swan, 31; business model risk, 195-196; causal relationships, 195; change blindness, 119-120; Countrywide, 6; credit risk, 204; critical issues, 194-195; decisionmaking, real-time, 119-120; derivatives, 29; estimated volatility, 201; fall of, 27-31; Freddie Mac, 5, 120; GAAP, 198; GSEs, 6, 28, 119-120, 202-205; hypotheses, identifying, 4; key assumptions, 201; liquidity, 5; models, building, 4; Monte Carlo modeling, 194-204; mortgages, guaranteeing, 5-6; new accounting, impact of, 197-203; OFHEO, 199; political risk, 119-120, 197, 204; price target distribution, 199; probabilistic estimate, 202; regulatory risk, 119-120; stock collapse, 31; stock price 2006-2007, 202 FDIC. See Federal Deposit Insurance Corporation Federal Deposit Insurance Corporation (FDIC), 107, 228 feedback, 17-18 feedback effects, 20-21, 173-174 feedforward, 17-18 financial fragility hypothesis, 19 Financials Select SPDR Fund index, 92 First American's Loan Performance servicing database, 88-89 Fitzpatrick, Tim, 141 forecast: accuracy, 23-24, 163; complexity, 163; modeling, 162-163; modeling/mapping, 162 forecasting in extreme environments: AMS, 9; Asch, Solomon, 15; avalanches, predicting, 10-11; Bagehot, Walter, 17; bank panics, 19-20; Bernanke, Ben, 19-20; Black, Fischer, 18; Black-Scholes option pricing model, 18; bubbles, classic theory, 12; butterfly effect, 8-10; calibration, 24-25; catalysts, 25-27;

accuracy, 23-24; Freddie Mac, 5; fully quantitative investing strategies, 22; fundamental research analysts, 24-25; Great Depression, 19-20; GSEs, 6, 28; hypotheses, identifying, 4; hypothesis, 22-23; imitation, 14-17, 21; investment thesis, 23; Ising, Ernst, 16–17; Ising model, 16–17, 21; Keynes, John Maynard, 25; Le Bon, Gustave, 14-15; leverage, 21; liquidity, 5; Lo, Andrew, 22; Lorenz, Edward, 8-9; markets and fundamentals, 19-21; Minsky, Hyman, 19; mob psychology, 14-15; models, building, 4; mortgages, guaranteeing, 5-6; nonlinear fundamentals, 7; null hypothesis, 24-25; Pastor, Lubos, 22-23; peer pressure, 15; phase shifts, 16-17, 21; quantitative investing, 22; rational herding, 15-16; reflexivity, 19; scientific method, 22-23, 26; selforganized criticality, 10-11; sensitive dependence on initial conditions, 8-9; Shaw, David E., 22; Shiller, Robert J., 11-12, 15; Simon, Herbert, 17-18; Soros, George, 19; South Sea Company, 12; stock collapse, 31; stock market crash of 1987, 18; traffic physics, 17; valuation, 24–25; Veronesi, Pietro, 22-23; wealth effect, 19; weather forecasting, 8-10 "forward repurchase commitments" contracts: judgment, 208-209, 212; Sallie Mae, 208-209, 212

CDOs, 13; collective behavior, 11–13,

15; Countrywide, 6; derivatives, 29;

discrimination, 23-24; earthquakes,

predicting, 10–11; *The Economist*, 17; extreme distributions, 10–11; extreme

volatility, 11-13, 15, 19-20; fall of,

27-31; Fannie Mae, 4-6, 28-30;

feedback, 17-18; feedback effects,

fragility hypothesis, 19; forecast

20-21; feedforward, 17-18; financial

Franklin, Benjamin, judgment, 212
Freddie Mac: cognitive dissonance, 147;
decision-making, real-time, 120;
Fannie Mae, 5; information
asymmetry, 146–148; information
overload, 93–94; Second-Quarter
2008 10-Q, 147
fully quantitative investing strategies, 22
fundamental research analysts, 24–25
fundamentals. See markets and
fundamentals

GE Capital, 112 generally accepted accounting standards (GAAP), 198 Gilad, Ben, 104, 143 Gladwell, Malcolm, 63 Golden West, 76, 144 government-sponsored enterprises (GSEs): decision-making, real-time, 119-120; Fannie Mae, 6, 28, 119-120, 202-205; judgment, 207-208; Monte Carlo modeling, 202-205; political risk, 197; Sallie Mae, 207-208 Graham, Benjamin, ix, 218, 221 Great Depression, 19–20 Greenblatt, Joel, 216-218 GSEs. See government-sponsored enterprises

"halting problem," 97–98, 213–214 Hammonds, Bruce, 223 home prices: 1975–2004, 189; 1975–2008, 190 housing markets, 186–188 hypotheses, 4 hypothesis, 22–23

imitation, 15–17 industry dissonance, 143 influence diagram, 39, 41, 53 information asymmetry: agenda control, 148–149; American Express, 139, information asymmetry (continued) 152-153; Capital One, 139-140; cognitive dissonance, 142-154; conflicting data, 145-146; Countrywide, 143; examples, 151-154; Fitzpatrick, Tim, 141; Freddie Mac, 146-148; Gilad, Ben, 143; Golden West, 144; industry dissonance, 143; interviews, 148-150; JP Morgan, 141-142; Mayo, Michael, 144-145; MOU, 139-140; option ARMs, 144; overcoming, 148-150; paradox of the three prisoners, 148-150; Providian, 151-153; rationality of, 144; Sallie Mae, 141–142, 154; selective disclosure, 139; Steel, Robert, 144–145; Wachovia Bancorp, 144-145 information overload, 96-98; ABX index, 88-91; Advance America, 106-109; Black Hawk Down, 101; Black Swan, 108; complexity theory, 98; computation, 96-98; critical issues, 100-102; developing, 99; entropy, 97; FDIC, 107; Financials Select SPDR Fund index, 92; First American's Loan Performance servicing database, 88-89; Freddie Mac, 93-94; Gilad, Ben, 104; "halting problem," 97-98; information strategy, 99-109; intuition, 101-102; Klein, Gary, 100-101; (in the) markets, 92-96; mathematical limits of, 97-98; media amplification, 94-96; payday lender, 106; physical limits, 96–97; Porter, Michael, 99; regulatory risk, 106-109; Shaw, David, 102; subprime mortgage crisis, 88-92; Turing, Alan, 97; Universal Turing Machine, 97 information strategy: Advance America, 106–109; biased information sources, 103-104; Black Hawk Down, 101; break down of, 103; brute-force

approach, 103; bureaucratic inertia, 105; communication overload, 104-105; critical issues, 100-102; data mining, 103; developing, 99; expert knowledge, 105; Gilad, Ben, 104; Klein, Gary, 100-101; limited resources, 105-106; low-cost information sources, 103–104; obstacles to, 102-106; Porter, Michael, 99 initial public offering (IPO), 157-161 interviews, 148-150 intuition, 62-63, 101-102, 162 investment thesis, 23 IPO. See initial public offering Ising, Ernst, 16-17 Ising model, 16–17, 21

Jeffrey, Richard, 41 Jensen, Johan, 46 Journal of Monetary Economics, 205 JP Morgan, 141-142, 209, 230-231 judgment: 11-standard-deviation surprise, 224; "affinity" credit cards, 222; algorithmic capital standards failure, 225-229; algorithms, 213-214, 216-221; Bank for International Settlements, 225–229; Bank of America, 223, 230-231; Basel I, 225; Basel II, 225-229; Black Swan, 234–235; Browne, Chris, 216–217; Buffett, Warren, 216-218; "The Buffett System," 216-218; capital ratios, 226; capital-market crash of 2007-2008, 233-234; causal relationships, 211, 233; CDS contract, 229-230; collective action, 234; competitors, 214–216; confidence, 213; cost of implementing in Europe, 227; critical issues, 211, 213; decisionmaking cycle, 215; definition, 212; denouement, 229-233; "dragon risk," 214; FDIC, 228; "forward repurchase commitments" contracts, 208-209,

212; Franklin, Benjamin, 212; Graham, Benjamin, 218, 221; Greenblatt, Joel, 216-218; GSE, 207-208; "halting problem," 213-214; Hammonds, Bruce, 223; JP Morgan, 209, 230-231; Khandani, Amir, 219-221; LBO, 230-231; Leibowitz, Marvin, 214; lessons learned, 232-233; leverage, 208; Lo, Andrew, 219-221; LTCMs, 208, 225-226; macroprudential orientation, 227-228; mapping, 213; MBNA, 221-224; mechanical judgment rules, 215; Minsky, Marvin, 207; mortgage underwriting models, 215; "Mr. Market," 218; multiple outcomes, 213; negative equity, 230-231; Peltzman, Sam, 228; "The Peltzman effect," 228; Quant Quake of 2007, 207, 218-221; quantitative shock of August 2007, 220; quantitative strategies, 218-221; risk management stumble, 221–224; Sallie Mae, 207-212, 229-233; Seidman, Bill, 228; strategy, 215-216; Turing, Alan, 213-214; value investing, 216-221; value investing style as algorithmic process, 217; VaR, 214; variable correlation, 213

Kahneman, Daniel, 68–70 Keynes, John Maynard, 25 Khandani, Amir, 219–221 Klein, Gary, 62–63, 100–101, 161–162 Kozlowski, Dennis, 112

Le Bon, Gustave, 14–15 legal risk, 180–184 Leibowitz, Marvin, 214 leverage: extreme volatility, 21; mapping, 160–162, 169–175; Sallie Mae, 208 leveraged buyout (LBO), 230–231 limited choices, 118 limited resources, 105–106 liquidity, 77 liquidity crisis, 5, 19–21 liquidity cycle, 189–190 litigation risk scenarios, 182 Lo, Andrew, 22 loan-level loss models, 80–81 Long-Term Capital Management (LTCM), 208 long-term hypotheses, 123 Lorenz, Edward, 8–9 loss models, 80–81, 82–83 low-cost information sources, 103–104 LTCM hedge fund, 185–186

macroprudential orientation, 227-228 Mandelbrot, Benoit, x many-to-one mapping, 173-174 mapping: American Express, 169–171; analysis simplification, 164–165; antitrust litigation, 159; Black Swan, 167; causal relationships, 171-175; causative significance of management incentives, 168; class action suit, 159-160; cognitive dissonance, 163; combinatorial explosion, 163-164; competition, 160-161; critical issues, 161, 170–173; critical issues, mapping to stock price, 165; feedback effects, 173-174; forecast accuracy, 163; forecast complexity, 163; forecast modeling, 162-163; forecast modeling, volatility, 162; intuition, 162; IPO, 157-161; judgment, 213; Klein, Gary, 161-162; lending, 171; leverage, 160-162, 169-175; many-to-one, 173-174; mental simulation, 162; Monte Carlo modeling, 173; one-tomany, 173-174; one-to-one, 173-174; output variable, 172; overconfidence, 163; premium customer base, 170; pricing power, 170; spending, 171; taxonomy of relationships, 173; Visa card, 157-161; Wal-Mart, 159 Marcus v. American Express, 181, 184 market price and volatility, 42

markets and fundamentals: bank panics, mob psychology, 14-15 19-20; Bernanke, Ben, 19-20; model-building, 4 extreme volatility, 18-22; feedback model-related overconfidence, 72-79 effects, 20-21; financial fragility Monte Carlo modeling: American hypothesis, 19; Great Depression, Express, 180-184; Black Swan, 179; 19-20; leverage, 21; Minsky, Hyman, business model risk, 195-196; call 19; reflexivity, 19; Soros, George, 19; option, 183-184; causal relationships, wealth effect, 19 195; causation, 192–194; causative MasterCard: American Express, variables, 191-192; CDO, 185-190; 183-184; American Express and, CDO-squareds, 186-188; collateral damage, 181; Congressional Budget 169–171; analysis simplification, 164-165; antitrust litigation, 159; Office, 205; consequences, 185–186; Black Swan, 167; causative significance correlation, 185-194; credit risk, 204; of management incentives, 168; class critical issues, 194-195; estimated action suit, 159-160; cognitive volatility, 201; Fannie Mae, 194-204; dissonance, 163; combinatorial GAAP, 198; GSEs, 202-205; home explosion, 163-164; competition, prices 1975-2004, 189; home prices 160-161; critical issues, 161; critical 1975-2008, 190; in housing markets, issues, mapping to stock price, 165; 186-188; introduction, 179-180; forecast accuracy, 163; forecast Journal of Monetary Economics, 205; complexity, 163; forecast modeling, key assumptions, 201; legal risk, 162-163; forecast modeling, volatility, 180–184; litigation risk scenarios, 182; 162; indexed stock price performance LTCM hedge fund, 185-186; 2007–2008, 176; intuition, 162; IPO, mapping, 173; Marcus v. American 157-161; Klein, Gary, 161-162; Express, 181, 184; MasterCard, mental simulation, 162; Monte Carlo 183–184; misestimating, 185–186; new modeling, 183-184; outcome, accounting, impact of, 197-203; 175-177; overconfidence, 163; stock normalized distributions, 189; price 2006-2007, 167; Wal-Mart, 159 no-surcharge rules, 181; OFHEO, 199; Mayo, Michael, 144-145 political risk, 197, 204; price target MBNA: 11-standard-deviation surprise, distribution, 199; principal components 224; "affinity" credit cards, 222; Bank analysis, 191-192; probabilistic of America, 223; Black Swan, 224; estimate, 202; put option, 199-200; Hammonds, Bruce, 223; judgment, risk factors, 182-183; standard 221–224; risk management stumble, deviation, 190; trading, 186–188; uses, 221-224; stock price 2004-2005, 224 180; volatility, 193 mechanical judgment rules, 215 mortgage underwriting models, 215 media amplification, 94-96 MOU. See memorandum of memorandum of understanding (MOU), understanding "Mr. Market," 218 139 - 140mental simulation, 162 multiple outcomes, 213 Minsky, Hyman, 19 Minsky, Marvin, 207 negative equity, 230-231

new accounting, 197-203

misestimating, 185-186

New Century Financial, 76 Newcourt, 111–112 nonlinear fundamentals, 7 normalized distributions, 189 no-surcharge rules, 181 null hypothesis, 24–25

OCC. See Office of the Comptroller of the Currency Office of Federal Housing Enterprise Oversight (OFHEO), 199 Office of the Comptroller of the Currency (OCC), 35 OFHEO. See Office of Federal Housing Enterprise Oversight one-to-many mapping, 173-174 one-to-one mapping, 173–174 option adjustable-rate mortgages (option ARMs), 144 option ARMs. See option adjustable-rate mortgages option market's view, 38 options market, 60-61 output variable, 172 overconfidence. See also confidence: in action, 65; Bank of America, 77-78; Countrywide, 72–78; Golden West stock volatility, 76; loan-level loss models, 80-81; mapping, 163; model related, 72-79; New Century Financial stock volatility, 76; properly specified loss models, 82-83; share of origination market, 74; standard deviation, 79-80; stock volatility, 76; subprime mortgage collapse, 76-84; vs. underconfidence, 59-60; Washington Mutual stock volatility, 76; Wells Fargo stock volatility, 76

paradox of the three prisoners, 148–150 Pastor, Lubos, 22–23 payday lender, 106 peer pressure, 15 Peltzman, Sam, 228 "The Peltzman effect," 228 phase shifts, 16-17, 21 physical limits, 96-97 political risk, 119-120, 197, 204 Porter, Michael, 99 practical techniques, 130-131 premium customer base, 170 price target distribution, 199 pricing power, 170 principal components analysis, 191-192 probabilistic estimate, 202 probability trees: accurate updating, 133; American Express stock price 1999-2000, 36; American Express stock price 1999-2002, 52; asymmetric outcomes, 44-48; Bayesian networks, 39; Capital One Financial Corporation stock price 1999-2000, 36; Capital One Financial Corporation stock price 1999-2002, 52; CIT Group, 114; correlations, 48-49; credit card companies, 33-34; critical issues, 40; Discover Financial Services, 133; discrimination, 43; expected value, 38; influence diagrams, 39; Jeffrey, Richard, 41; Jensen, Johan, 46; Jensen's inequality, 46-47; market price and volatility, 42; OCC, 35; option market's view, 38; Providian, 36–54; Providian, conclusions, 49–52; Providian, influence diagram, 41, 53; Providian, lesson learned, 52-54; research, 45; risk factors, 47-48; volatility, introduction to, 35-39 properly specified loss models, 82–83 Providian: Black Swan, 33-39, 51; conclusions, 49-52; conditional probabilities, 126; critical issues, 40; decision tree for new information, 127; decision-making, real-time, 126-128; expected value, 38; influence diagram, 41, 53; information asymmetry, 151-153; lesson learned,

Providian (continued)
52–54; market price and volatility, 42;
OCC, 35; option market's view, 38;
probability trees, 36–54; real-time
updating strategy, 126–128; research,
45; revised probability, 126–128; stock
price 1997–2000, 34; stock price
1999–2000, 36, 52
put option, 60, 199–200

Quant Quake of 2007, 207, 218–221 quantitative investing, 22 quantitative shock of August 2007, 220 quantitative strategies, 218–221

rational herding, 15-16 real-time decision-making. See decisionmaking, real-time real-time updating strategy: CIT Group, 128; conditional probabilities, 126; decision tree for new information, 127; decision-making, real-time, 125-129; diagnostic power of new information, 125; Providian, 126-128; revised probability, 126-128; SAMs, 129 reflexivity, 19 regulatory risk, 106-109, 119-120 representativeness heuristic, 68–72 research, 45 revised probability, 126-128 risk factors: American Express, 182-183; CIT Group, 113; decision-making, real-time, 113; Monte Carlo modeling, 182–183; probability trees, 47–48 risk management stumble, 221–224

Sallie Mae: Bank of America, 230–231; causal relationships, 211, 233; CDS contract, 229–230; critical issues, 211; denouement, 229–233; Fitzpatrick, Tim, 141; "forward repurchase commitments" contracts, 208–209, 212; GSE, 207–208; information

asymmetry, 141-142, 154; JP Morgan, 209, 230–231; judgment, 207–212, 229-233; LBO, 230-231; lessons learned, 232-233; leverage, 208; LTCM, 208; negative equity, 230-231; stock price 2000-2006, 210; stock price 2006–2009, 232 SAMs. See surface-to-air missiles scientific method, 22-23, 26 Seidman, Bill, 228 selective disclosure, 139 self-image, 117-118 self-organized criticality, 10-11 the "sell decision," 131 sensitive dependence on initial conditions, 8-9 Shaw, David, 22, 102 Shiller, Robert J., 11–12, 15 short strangle, 60-61 Simon, Herbert, 17-18 Soros, George, 19 South Sea Company, 12 spending, 171 standard deviation, 79-80, 190, 224 Steel, Robert, 144-145 stock collapse, 31 stock market crash of 1987, 18 stock price: Advance America 2005-2006, 108-109; American Express 1999-2000, 36; American Express 1999–2002, 52; American Express 2005-2006, 184; American Express indexed performance 2007–2008, 176; Capital One Financial Corporation 1999–2000, 36; CIT Group 2002–2003, 115; CIT Group 2007–2008, 59; confidence, 59; Countrywide 1999-2006, 74; Countrywide 2006–2008, 78; Fannie Mae 2006-2007, 202; information overload, 108-109; MasterCard 2006-2007, 167; MasterCard indexed performance 2007-2008, 176; MBNA 2004-2005, 224; probability trees,

34, 36, 37, 52; Providian 1997–2000, 34; Providian 1999–2002, 52; Sallie Mae 2000–2006, 210; Sallie Mae 2006–2009, 232 stock volatility, 76 stubbornness, 122–123 subprime mortgage crisis, 76–84, 88–92 surface-to-air missiles (SAMs), 115, 129

Taleb, Nassim Nicholas, x trading, 186–188 traffic physics, 17 Turing, Alan, 97, 213–214 Tversky, Amos, 68–70 Tyco, 112

underconfidence, 66. *See also* confidence Universal Turing Machine, 97

valuation, 24–25 value investing, 216–221, 217

value-at-risk (VaR), 214
variable correlation, 213
Veronesi, Pietro, 22–23
Visa card: American Express and, 169–171; antitrust litigation, 159; class action suit, 159–160; competition, 160–161; mapping, 157–161; Wal-Mart, 159
VIX. See Chicago Board Options
Volatility Index
volatility. See also extreme volatility: correlation, 193; decision-making, real-time, 124–125; introduction to, 35–39; Monte Carlo modeling, 193; probability trees, 35–39

Wachovia Bancorp, 144–146 Washington Mutual, 76 wealth effect, 19 weather forecasting, 8–10 Wells Fargo, 76 wishy-washiness, 122–123

