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978-1-107-04811-9 - Portfolio Management Under Stress: A Bayesian-Net Approach to Coherent Asset Allocation

Riccardo Rebonato and Alexander Denev

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## Portfolio Management Under Stress

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*Portfolio Management Under Stress* offers a novel way to apply the well-established Bayesian-net methodology to the important problem of asset allocation under conditions of market distress or, more generally, when an investor believes that a particular scenario (such as the break-up of the Euro) may occur. Employing a coherent and thorough approach, it provides practical guidance on how best to choose an optimal and stable asset allocation in the presence of user-specified scenarios or ‘stress conditions’. The authors place causal explanations, rather than association-based measures such as correlations, at the core of their argument, and insights from the theory of choice under ambiguity aversion are invoked to obtain stable allocations results. Step-by-step design guidelines are included to allow readers to grasp the full implementation of the approach, and case studies provide clarification. This insightful book is a key resource for practitioners and research academics in the post-financial-crisis world.

RICCARDO REBONATO is Global Head of Rates and FX Analytics at PIMCO, and a visiting lecturer in Mathematical Finance at Oxford University (OCIAM). He has previously held positions as Head of Risk Management and Head of Derivatives Trading at several major international financial institutions. Dr Rebonato has been on the Board of ISDA (2002–2011), and still serves on the Board of GARP (2001 to present). He is the author of several books on finance and an editor for several journals (*International Journal of Theoretical and Applied Finance*, *Journal of Risk*, *Applied Mathematical Finance*, *Journal of Risk for Financial Institutions*).

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‘Standard portfolio theory has been shown by recent events to have two major shortcomings: it does not deal well with extreme events and it is often based on mechanical statistical procedures rather than modelling of fundamental causal mechanisms. In this book, Rebonato and Denev put forward an interesting approach for dealing with both of these problems. Their method is flexible enough to accommodate individual views of underlying causal mechanisms, but disciplined enough to ensure that decisions do not ignore the data. Anyone with a serious interest in making good portfolio decisions or measuring risk will benefit from reading this book.’

**Ian Cooper, Professor of Finance, London Business School**

‘This book is self-contained in that it covers a lot of familiar but diverse material from a fresh perspective. Its purpose is to take an ambitious new approach to combining this material into a coherent whole. The result is a new methodology for practical portfolio management based on Bayesian nets, which satisfactorily takes into simultaneous account both normal and extreme market conditions. While readers may themselves be under stress in absorbing the details of the new approach, serious fund managers and finance academics will ignore it at their peril.’

**M. A. H. Dempster, Emeritus Professor, Department of Mathematics,  
University of Cambridge; Cambridge Systems Associates Limited**

‘Rebonato and Denev have demolished the status quo with their radical extension of best-practice portfolio management. The key is to integrate realistic “extreme” scenarios into risk assessment, and they show how to use Bayesian networks to characterize precisely those scenarios. The book is rigorous yet completely practical, and reading it is a pleasure, with the “Rebonato touch” evident throughout.’

**Francis X. Diebold, Paul F. and Warren S. Miller Professor of  
Economics, Professor of Finance and Statistics, and Co-Director, Wharton  
Financial Institutions Center, University of Pennsylvania**

‘Here is a book that combines the soundest of theoretical foundations with the clearest practical mindset. This is a rare achievement, delivered by two renowned masters of the craft, true practitioners with an academic mind. Bayesian nets provide a flexible framework to tackle decision making under uncertainty in a post-crisis world. Modeling observations according to causation links, as opposed to mere association, introduces a structure that allows the user to *understand* risk, as opposed to just measuring it. The ability to define scenarios, incorporate subjective views, model exceptional events, etc., in a rigorous manner is extremely satisfactory. I particularly liked the use of concentration constraints, because history shows that high concentration with low risk can be more devastating than low

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concentration with high risk. I expect fellow readers to enjoy this work immensely, and monetize on the knowledge it contains.'

**Marcos Lopez de Prado, Research Fellow, Harvard University;  
Head of Quantitative Trading, Hess Energy Trading Company**

'In a recent book of my own I bemoan rampant "confusion" among academics as well as practitioners of modern financial theory and practice. I am delighted to say that the authors of *Portfolio Management Under Stress* are *not* confused. It is heart-warming to find such clarity of thought among those with positions of great influence and responsibility.'

**Harry M. Markowitz, Nobel Laureate, Economics 1990**

'Rebonato and Denev have ploughed for all of us the vast field of applications of Bayesian nets to quantitative risk and portfolio management, leaving absolutely no stone unturned.'

**Attilio Meucci, Chief Risk Officer and Director of  
Portfolio Construction at Kepos Capital LP**

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# Portfolio Management Under Stress

A Bayesian-Net Approach to  
Coherent Asset Allocation

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University Printing House, Cambridge CB2 8BS, United Kingdom

Cambridge University Press is a part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning and research at the highest international levels of excellence.

[www.cambridge.org](http://www.cambridge.org)

Information on this title: [www.cambridge.org/9781107048119](http://www.cambridge.org/9781107048119)

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First published 2013

Printed in the United Kingdom by CPI Group Ltd, Croydon CR0 4YY

*A catalogue record for this publication is available from the British Library*

*Library of Congress Cataloguing in Publication data*

Rebonato, Riccardo.

Portfolio management under stress : a Bayesian-net approach to coherent asset allocation / Riccardo Rebonato and Alexander Denev.

pages cm

Includes bibliographical references and index.

ISBN 978-1-107-04811-9 (hardback)

1. Portfolio management – Mathematical models. 2. Investments – Mathematical models. 3. Financial risk – Mathematical models. I. Denev, Alexander. II. Title.

HG4529.5.R43 2013

332.601'519542 – dc23 2013037705

ISBN 978-1-107-04811-9 Hardback

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To my father, my wife and my son.

[RR]

To my mother and brother. What I am today, I owe to them.

[AD]

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The figures of the Bayesian net were drawn with Netica from Norsys Software Corp. ([www.norsys.com](http://www.norsys.com)).

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## *Acknowledgements*

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We would like to thank the many friends, colleagues, academics and professionals who have helped us by providing suggestions and correcting our errors.

In particular, we would like to acknowledge the help received by Professor Didier Sornette for the parts of book on econophysics, Sir David Forbes Hendry for his comments on our discussion of predictability in finance, Dr Attilio Meucci for the parts on entropy pooling, Professors Uppal and Garlappi for reviewing our treatment of ambiguity aversion, Professor Stoyan Stoyanov, who gave us useful pointers on the conceptual links between Extreme Value Theory, Pareto distributions and econophysics, Dr Vasant Naik for discussing with us the sections on private valuation, Professor Diebold for his support of the general approach, Dr Marcos Lopez de Prado, Ms Jean Whitmore, Mr Sebastien Page, Dr Vineer Bhansali and Dr Richard Barwell for general discussions and comments on the structure of the book, and two anonymous referees, whose comments have substantively improved both the content of the book and the presentation of the material.

We are very grateful to Cambridge University Press, and Dr Chris Harrison in particular, for the enthusiasm with which they have accepted our proposal, and for the rigour and constructive nature of the reviewing process. We found in Ms Mairi Sutherland an excellent editor, who has managed to navigate successfully the difficulties inherent in dealing with a manuscript which had patently been written *a quattro mani*.

We are, of course, responsible for all the remaining errors.