

Table of Contents

Foreword	xi
Rama CONT	
Introduction	xv
Notations and Acronyms	xxi
Chapter 1. Factor Models and General Definition	1
1.1. Introduction	1
1.2. What are factor models?	2
1.2.1. Notations	2
1.2.2. Factor representation	4
1.3. Why factor models in finance?	7
1.3.1. Style analysis	7
1.3.2. Optimal portfolio allocation	10
1.4. How to build factor models?	11
1.4.1. Factor selection	11
1.4.2. Parameters estimation	13
1.5. Historical perspective	14
1.5.1. CAPM and Sharpe's market model	14
1.5.2. APT for arbitrage pricing theory	17
1.6. Glossary	18

Chapter 2. Factor Selection	23
2.1. Introduction	23
2.2. Qualitative know-how	24
2.2.1. Fama and French model	25
2.2.2. The Chen <i>et al.</i> model	26
2.2.3. The risk-based factor model of Fung and Hsieh	27
2.3. Quantitative methods based on eigenfactors	31
2.3.1. Notation	32
2.3.2. Subspace methods: the Principal Component Analysis	33
2.4. Model order choice	36
2.4.1. Information criteria	36
2.5. Appendix 1: Covariance matrix estimation	38
2.5.1. Sample mean	39
2.5.2. Sample covariance matrix	40
2.5.3. Robust covariance matrix estimation: M-estimators	43
2.6. Appendix 2: Similarity of the eigenfactor selection with the MUSIC algorithm	46
2.7. Appendix 3: Large panel data	48
2.7.1. Large panel data criteria	49
2.8. Chapter 2 highlights	56
Chapter 3. Least Squares Estimation (LSE) and Kalman Filtering (KF) for Factor Modeling: A Geometrical Perspective	59
3.1. Introduction	59
3.2. Why LSE and KF in factor modeling?	60
3.2.1. Factor model per return	60
3.2.2. Alpha and beta estimation per return	61
3.3. LSE setup	62
3.3.1. Current observation window and block processing	62

3.3.2. LSE regression	62
3.4. LSE objective and criterion	63
3.5. How LSE is working (for LSE users and programmers)	64
3.6. Interpretation of the LSE solution	65
3.6.1. Bias and variance	65
3.6.2. Geometrical interpretation of LSE	66
3.7. Derivations of LSE solution	70
3.8. Why KF and which setup?	71
3.8.1. LSE method does not provide a recursive estimate	71
3.8.2. The state space model and its recursive component	72
3.8.3. Parsimony and orthogonality assumptions	73
3.9. What are the main properties of the KF model?	74
3.9.1. Self-aggregation feature	74
3.9.2. Markovian property	75
3.9.3. Innovation property	75
3.10. What is the objective of KF?	76
3.11. How does the KF work (for users and programmers)?	77
3.11.1. Algorithm summary	77
3.11.2. Initialization of the KF recursive equations	80
3.12. Interpretation of the KF updates	81
3.12.1. Prediction filtering, equation [3.34]	81
3.12.2. Prediction accuracy processing, equation [3.35]	82
3.12.3. Correction filtering equations [3.36]–[3.37]	83
3.12.4. Correction accuracy processing, equation [3.38]	84

3.13. Practice	86
3.13.1. Comparison of the estimation methods on synthetic data	86
3.13.2. Market risk hedging given a single-factor model	92
3.13.3. Hedge fund style analysis using a multi-factor model	97
3.14. Geometrical derivation of KF updating equations	104
3.14.1. Geometrical interpretation of MSE criterion and the MMSE solution .	104
3.14.2. Derivation of the prediction filtering update	106
3.14.3. Derivation of the prediction accuracy update	106
3.14.4. Derivation of the correction filtering update	107
3.14.5. Derivation of the correction accuracy update	111
3.15. Highlights	112
3.16. Appendix: Matrix inversion lemma	116
Chapter 4. A Regularized Kalman Filter (rgKF) for Spiky Data	117
4.1. Introduction	117
4.2. Preamble: statistical evidence on the KF recursive equations	119
4.3. Robust KF	119
4.3.1. RKF description	119
4.4. rgKF: the $\text{rgKF}(\text{NG}, l^q)$	121
4.4.1. rgKF description	121
4.4.2. rgKF performance	125

4.5. Application to detect irregularities in hedge fund returns	128
4.6. Conclusion	130
4.7. Chapter highlights	130
Appendix: Some Probability Densities	133
Conclusion	141
Bibliography	143
Index	153