Contents

List of Figures xvii
List of Tables xxvii

1. Introduction and Roadmap **1**
1.1 Behaviour and Rationality 4
1.2 'Anomalies' 6
1.3 Environment and Evolution 8
1.4 The Traditional Investment Paradigm 9
1.5 A New World Order 12
1.6 The Adaptive Markets Hypothesis 15
1.7 Practical Implications 19
1.8 Organizational Structure of the Book 25

I. FOUNDATIONS

2. The Origin of Behaviour **31**
2.1 The Binary Choice Model 39
2.2 Probability Matching 47
2.3 Risk Preferences 52
2.4 Idiosyncratic versus Systematic Risk 63
2.5 Discussion 69

3. Mutation **73**
3.1 Environments with Mutation 75
3.2 The Optimal Degree of Irrationality 80
3.3 Generalization and Simulation 83
3.4 Discussion 87

4. Group Selection **91**
4.1 Environments with Factor Structure 94
4.2 Individual versus Group Optimality 98
4.3 Multinomial Choice with Multiple Factors 99
4.4 A Numerical Example 102
4.5 Discussion 105

II. BEHAVIOUR

5. Probability Matching 111
- 5.1 The Binary Choice Game 113
- 5.2 Summary Statistics 116
- 5.3 A Model of Individual Behaviour 118
- 5.4 Initial Learning 119
- 5.5 Decision Autocorrelation 121
- 5.6 Probability Matching 121
- 5.7 Individual Differences 124
- 5.8 Discussion 126

6. Risk Aversion 129
- 6.1 Environments with Mixed Risks 131
- 6.2 Individual Preferences 134
- 6.3 Risk Aversion and Systematic Risk 135
- 6.4 Common Distributions of Relative Fecundity 137
- 6.5 Testable Implications 140
- 6.6 Discussion 145

7. Cooperation 149
- 7.1 Environments with Interactions 150
- 7.2 Behavioural Implications 165
- 7.3 Discussion 168

8. Bounded Rationality and Intelligence 171
- 8.1 Environments with Intelligence 173
- 8.2 An Evolutionary Definition of Intelligence 176
- 8.3 Bounded Rationality 177
- 8.4 A Universal Measure of Intelligence and its Cost 178
- 8.5 Upper Bound on Correlation 180
- 8.6 Intelligence across Generations 181
- 8.7 Discussion 185

9. Learning to be Bayesian 189
- 9.1 Environments with States 190
- 9.2 Bayesian Behaviours in Stationary Environments 192
- 9.3 What is Intelligence? Revisited 196
- 9.4 Finite Memory in Nonstationary Environments 197
- 9.5 Sampling with Limited Information 200
- 9.6 Discussion 201

10. The Madness of Mobs 203
- 10.1 Political Polarization 208
- 10.2 Bias and Discrimination 214
- 10.3 Practical Implications 227
- 10.4 Discussion 229

III. NEURONS

11. Fear, Greed, and Financial Crises **235**
- 11.1 A Brief History of the Brain 237
- 11.2 Fear 240
- 11.3 Greed 245
- 11.4 Risk 249
- 11.5 Rationality 251
- 11.6 Sentience 256
- 11.7 Interactions Among Components 259
- 11.8 Evolution at the Speed of Thought 263
- 11.9 Practical Implications 265
- 11.10 Discussion 268

12. The Psychophysiology of Trading **273**
- 12.1 Measuring Emotional Response 274
- 12.2 Experimental Design 278
- 12.3 Results 282
- 12.4 Discussion 289

13. What Makes a Good Day Trader? **295**
- 13.1 Risk-Taking and Emotion 296
- 13.2 Experimental Design 301
- 13.3 Results 304
- 13.4 Discussion 311

IV. FINANCIAL MARKET DYNAMICS

14. A Computational View of Market Efficiency **315**
- 14.1 The Model 319
- 14.2 A Computational Definition of Market Efficiency 321
- 14.3 Market Evolution 323
- 14.4 A Financial Turing Test 326
- 14.5 Experimental Design 327
- 14.6 Synthetic Processes and Results 331
- 14.7 Discussion 340

15. Maximizing Relative versus Absolute Wealth **343**
- 15.1 The Kelly Criterion 345
- 15.2 Maximizing Relative Wealth 347
- 15.3 A Numerical Example 352
- 15.4 Testable Implications 355
- 15.5 Discussion 356

16. Hedge Funds: The Galápagos Islands of Finance 359
16.1 Hedge Fund Characteristics 361
16.2 An Overview of Hedge Fund Return Data 367
16.3 Investment Performance 378
16.4 Illiquidity 390
16.5 Hedge Fund Risks 398
16.6 The Financial Crisis 421
16.7 Implementation Issues for Hedge Fund Investing 437
16.8 Discussion 461

17. What Happened to the Quants in August 2007? 463
17.1 The Data 468
17.2 Factor Portfolios 470
17.3 Measures of Market Liquidity 480
17.4 Discussion 504

V. FINANCIAL INSTITUTIONS AND ADAPTATION

18. The Co-Evolution of Financial Markets and Technology 511
18.1 Historical Context 511
18.2 The Evolution of Technology and Finance 514
18.3 Timetable of Financial Evolution 518
18.4 The Eight Eras of Financial Evolution 523
18.5 Discussion 548

19. The Role of Culture in Finance 551
19.1 What is Culture? 553
19.2 What Determines Corporate Values? 554
19.3 Examples from the Financial Industry 573
19.4 Regulatory Culture 577
19.5 The Importance of Feedback Loops 581
19.6 Behavioural Risk Management 582
19.7 Discussion 588

20. Regulation and Adaptive Markets 589
20.1 Measures of Systemic Risk 594
20.2 The Shadow Banking System 599
20.3 The Shadow Hedge Fund System 603
20.4 Behavioural Foundations of Systemic Risk 606
20.5 A Process for Regulatory Design and Reform 612
20.6 The Capital Markets Safety Board 615
20.7 Transparency and Fair Value Accounting 619
20.8 The Role of Technology and Education 624
20.9 The Role of Corporate Governance 631
20.10 Discussion 634

Epilogue 637

A. Notational Glossary 639

B. Proofs and Additional Results 643
B.1 Chapter 2: The Binary Choice Model 643
B.2 Chapter 3: Mutation 646
B.3 Chapter 4: Group Selection 653
B.4 Chapter 6: Risk Aversion 656
B.5 Chapter 7: Cooperation 657
B.6 Chapter 8: Bounded Rationality 671
B.7 Chapter 9: Learning to be Bayesian 677
B.8 Chapter 10: The Madness of Mobs 681
B.9 Chapter 14: A Computational View of Market Efficiency 683
B.10 Chapter 15: Maximizing Relative versus Absolute Wealth 684
B.11 Chapter 17: What Happened to the Quants in August 2007? 687

C. Psychophysiological Methodology 693
C.1 Subjects 693
C.2 Physiological Data Collection 693
C.3 Physiological Data Feature Extraction 695
C.4 Financial Data Collection 696
C.5 Financial Data Feature Extraction 697

References 701
Index 749