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$i = \sqrt{2} TDV + \sum \delta_i (TDV_i, T+h) + \epsilon T+h i=1$  That is, determine the value for the time trend at time T + h and set the dummy variables to their appropriate 0 or 1 values for the period T + h. negative covariance dependence. .9756 . MODULE QUIZ 14.2 1. P(A) × P(B) = P(AB). The standard deviation of this minimum risk portfolio is approximately 17%. (LO 23.c) 2. Multicollinearity refers to when two or more of the independent variables, or linear combinations of the independent variables, in a multiple regression are highly correlated with each other. We can also extend the first effect and show that the correlation is scale free and is either +1 or -1 when a or b are not equal to zero. 1.44 and 1.23 5. Given this information, calculate the sample mean, variance, and standard deviation. The standard error of the regression (SER) measures the uncertainty about the accuracy of the predicted values of the dependent variable. The probability of success, p, may be denoted with the value 1 and the probability of failure, 1 - p, may be denoted with the value 0. Wald's theorem proposes a way to model the role of white noise and holds that a covariance stationary process can be modeled as an infinite distributed lag of a white noise process. .8888 . z = 4.00. Notice also that the third simulation sample includes the same observation (x1) twice. Thus, the values in the z-table are the probabilities of observing a z-value that is less than a given value, z [i.e., P(Z < z)]. The alternative hypothesis, designated HA, is what is concluded if there is sufficient evidence to reject the null hypothesis. Graphically, a white noise process resembles Figure 21.2, with no identifiable patterns among the time periods. 0.9738. A third effect of linear transformations on covariance is that the scale of covariance is determined by two variables, b and d, as follows: Cov[a + bX1, c + dX2] = bCov[X1, X2] The fourth effect of linear transformations on covariance between random variables relates to coskewness and cokurtosis. New York, NY: Pearson, 2019. Finally, be able to describe the advantages and disadvantages of the bootstrapping technique in comparison to the traditional Monte Carlo approach. A The antithetic variate technique reduces Monte Carlo sampling error by rerunning the simulation using a complement set of the original set of random variables. 0.6217. In addition, all 50 stocks in the sample come from two industries, electric utilities or biotechnology. (page 114) 7. (LO 15.i) 2. explain mean reversion and calculate a mean-reverting level. 8.455 to 8,876. Bob Shepperd is trying to forecast 10-year T-bond yield. m-fold cross-validation: involves dividing the sample into m parts and then using (m-1) parts (known as the training set) to fit the model and the remaining part (known as the validation block) to use for out-of-sample validation. High computational costs arise with complex problems. C The coefficients column contains the regression parameters. The forecaster should especially consider these alternatives if he notices periodic spikes in the autocorrelations as they are gradually decaying. The first column denotes the respective year for each return. Note that n1 - 1 and n2 - 1 are the degrees of freedom used to identify the appropriate critical value from the F-table (provided in the Appendix). 0.9599. The test statistic is the value that a decision about a hypothesis will be based on. IND = industry quartile ranking (IND = 4 is the highest ranking) FORT = Fortune 500 firm, where {FORT = 1 if the stock is that of a Fortune 500 firm, FORT = 0 if not a Fortune 500 stock} The regression results are presented in the following table. D OLS is a process that minimizes the sum of squared residuals to produce estimates of the population parameters known as sample regression coefficients. LO 23.c The first two moments of a probability density function are its mean and variance, which are used to describe a normal distribution. In this case, we cannot forecast based on past values. To see how this is applied, take two random variables (X1,Y1) and (X1,Y1). In particular, it needs the relationships among its present and past values to remain stable over time. (page 174) e. Figure 16.3 summarizes the number of measures required for each cross moment. Learning Objectives and Reading Assignments 2. A PDF allows us to calculate the probability of an outcome between two values (over an interval). 5.13%. 0.7517. 0.0324 . 0.9608. For a Monte Carlo process, this data is drawn from an assumed data generating process (DGP). Assume the population standard deviation is 20.0%. Results of most Monte Carlo experiments are difficult to replicate. MODULE 24.2: BOOTSTRAPPING AND RANDOM NUMBER GENERATION The Bootstrapping Method LO 24.d: Describe the bootstrapping method and its advantage over Monte Carlo simulation. 0.9920. Hypothesis testing procedures, based on sample statistics and probability theory, are used to determine whether a hypothesis is a reasonable statement and should not be rejected or if it is an unreasonable statement and should be rejected. It makes intuitive sense that sales in the current period could be affected by both past sales and by random shocks, such as advertising. MODULE QUIZ 15.2 1. Using a sample consisting of 54 observations, the researcher found that RSS in the model with three explanatory variables is 6,650 while the RSS in the single variable model is 7,140. To conduct a t-test, the t-statistic is compared to a critical t-value at the desired level of significance with the appropriate degrees of freedom. Best Linear Unbiased Estimator LO 16.e: Explain what is meant by the statement that the mean estimator is BLUE. (page 195) d. The adjusted R2 value is expressed as: 2 Ra = 1 - ((n-1 n-k-1 2) × (1 - R) ) where: n = number of observations k = number of independent variables Note that R will be less than or equal to R2. The F-Distribution Hypotheses concerning the equality of the variances of two populations are tested with an F-distributed test statistic. 0.9222. 0.324 3. .5319 . 1 B. Thus, the sample mean is simply an estimate of the true population mean. The return over the next period is a random variable, and a simulation model estimates multiple scenarios to represent future returns based on a probability distribution of possible outcomes. It is only an estimate of the true population mean. Evaluate the following statements: I. For example, an ARMA(3,1) model means three lagged operators in the AR portion of the formula and one lagged operator on the MA portion. Answer Key for Modules Quizzes 4. For a test about the value of the mean of a distribution: test statistic= sample mean-hypothesized mean standard error of sample mean LO 17.b A two-tailed test results from a two-sided alternative hypothesis (e.g., HA: μ ≠ μ0). LO 22.c A time series is a random walk if its value in any given period is its previous value plus-or-minus a random "shock." A random walk is not covariance stationary. MODULE QUIZ 18.1 1. 0.1152 From the table, the first step is to compute the deviation from the mean. E(RP) = 1.70 + (1.03 × 8) - (0.23 × 2) + (0.32 × 3) = 10.44% 2. Application of AR, MA, and ARMA processes LO 21.i: Describe the application of AR, MA and ARMA processes. For example, a model for quarterly time series can have up to three seasonal dummy variables, and a model for a monthly time series can have up to 11. Time series with unit roots should be analyzed in terms of their change from the previous period. From the previous example, we know the test statistic for the option return sample is 6.33. R2 = ESS/TSS = % of variation explained by the regression model Recall that for a single regression, R2 = r2X,Y. LO 15.b A marginal distribution defines the distribution of a single component of a bivariate random variable (i.e., a univariate random variable). Seasonality in a time series can also refer to cycles shorter than a year. 0. For example, P(X = 3) = C(3) = 3!/0! = 30%. The expectation of a sum is always the sum of the expectations. Figure 16.3: Cross Moment Measurements Cross Moment Number of Measurements 1st 0 cross means 2nd 1 covariance (cross variance) 3rd 2 coskewness (cross skewness) 4th 3 cokurtosis (cross kurtosis) Dividing by the variance of one variable and the standard deviation of the other variable standardizes the cross third moment. The variance of the sum of four i.i.d. random variables is equal to 6σ2. The probability that A will occur, given that B has occurred, is written as P(A|B). The sum of all probabilities of each outcome occurring must always equal 100%. 0.5199 . the test statistic will increase. Thus, the 95% confidence interval for the return, R, is: 10.5 ± 1.96(18) = -24.78% to 45.78% Symbolically, this result can be expressed as: P(-24.78 < R < 45.78) = 0.95 or 95% The interpretation is that the annual return is expected to be within this interval 95% of the time, or 95 out of 100 years. For example, a researcher may be interested in the mean daily return on stock options. In the third column, the mean is subtracted from the observed value, Xi. In the fourth column, the deviations from the mean in the third column are squared. For OLS to generate the best linear unbiased estimator (BLUE), the assumptions underlying the linear regression need to be satisfied. (page 51) f. Excess kurtosis is measured relative to 3, the kurtosis of the normal distribution. On average, 50% of the variable's outcomes will be below the median and 50% of the variable's outcomes will be above the median. For example, if we regress a monthly time series against its year-ago values, we get a partial autocorrelation for τ = 12 that does not account for any effects from other lags. As you will see in the next reading, this is why the slope coefficients in a multiple regression are sometimes called partial slope coefficients. For the exam, be prepared to explain and calculate the mean and variance for bivariate random variables. 2.5%. 0.9826 . 0.9970. Jarque-Bera Test LO 23.d: Explain how the Jarque-Bera test is used to determine whether returns are normally distributed. The size of silver particles in a photographic solution B. With b < 0 (a decreasing transformation), the magnitude of the skew is unaffected, but the sign is changed, skew Y = -skew X Reading 19: Regression with Multiple Explanatory Variables 1. MODULE 13.1: PROBABILITY MASS FUNCTIONS, CUMULATIVE DISTRIBUTION FUNCTIONS, AND EXPECTED VALUES Random Variables and Probability Functions LO 13.a: Describe and distinguish a probability mass function from a cumulative distribution function and explain the relationship between these two. Figure 14.3: Confidence Intervals for a Normal Distribution In practice, we will not know the actual values for the mean and standard deviation of the distribution, but will have estimated them as X and s. Because of unreliable standard errors, hypothesis testing is unreliable. The probability that a random variable will have a specific outcome, given that some other outcome has occurred, is referred to as a conditional probability. The test statistic (z-value) = (2.0 - 0.0) / (20.0 / 6) = 0.60. In the standard regression equation Yi = α + βXi + εi, if Y and X are standardized such that they each have a variance of one (termed, unit variance), the correlation will be equal to the regression slope (β). B The regression equation can be written as: E(Y) = α + β × X. 0.9732. Reading 24: Simulation and Bootstrapping 1. Figure 17.3 shows the relationship between the level of significance, the power of a test, and the two types of errors. Variables are all from a single univariate distribution. Attenuation bias: This occurs when X variables are measured with error and leads to underestimation of the regression coefficients. Figure 14.7 illustrates the shapes of the t-distribution associated with different degrees of freedom. The magnitude of the residuals would then be standardized and any residual over ±4 standard deviations would be considered problematic. Most top firms employ at least one financial risk manager. distinguish between an estimator and an estimate. The trinomial distribution has three parameters: the number of trials (n), the probability of observing outcome 1 (p1), and the probability of observing outcome 2 (p2). On the flip of one coin, the occurrence of the event "heads" may be used to assign the value of one to a random variable. Getting heads on the first flip does not change the probability of getting heads on the second flip. The bootstrapping approach draws random return data from a sample of historical data. Skewness and kurtosis are critical concepts for risk management because when securities returns are modeled using an assumed normal distribution, the predictions from the models will not take into account the potential for extremely large, negative outcomes. Autoregressive models are the most widely applied time series models in finance. explain the relationship between the covariance and correlation of two random variables and how these are related to the independence of the two variables. MODULE 15.3: BEHAVIOR OF MOMENTS FOR BIVARIATE RANDOM VARIABLES Linear Transformations LO 15.f: Explain the effects of applying linear transformations on the covariance and correlation between two random variables. Multicollinearity refers to the condition when two or more of the independent variables, or linear combinations of the independent variables, in a multiple regression are highly correlated with each other. MODULE QUIZ 15.4 1. describe a random walk and a unit root. As the number of lags or displacements becomes large, autocorrelation functions (ACFs) will approach A. For a sample size of n, a block size of √n is generally appropriate. However, increasing the number of generated scenarios can become costly for more complex multi-period simulations. 2.3%. The variance of the average of multiple i.i.d. random variables A. The event space is heads, tails, heads and tails, and neither heads nor tails. biotechnology industry P/Es are statistically significantly larger than electric utilities industry P/Es, holding DPO, G, and B constant. PROFESSOR'S NOTE Just as MA models can be extrapolated to the qth observation and AR models can be taken out to the pth observation, ARMA models can be used in the format of an ARMA(p,q) model. Answer: We first need to convert the seconds into minutes. Alternate assumptions made in the DGP may lead to substantially different results. Now, suppose we want to increase the accuracy by reducing the standard error estimate. a Type I error will increase. The first moment, the mean of a random variable, is its expected value, E(X), which we discussed previously. A special type of serially uncorrelated series is one that has a mean of zero and a constant variance. Even though the coefficient estimates are unbiased and consistent, the estimated standard errors are unreliable in the presence of conditional heteroskedasticity. To convert an autocovariance function to an autocorrelation function (ACF), we divide the autocovariance at each τ by the variance of the time series. Antithetic Variates LO 24.c: Explain the use of antithetic and control variates in reducing Monte Carlo sampling error. LO 18.f: Explain the steps needed to perform a hypothesis test in a linear regression. A conditional PMF is used to determine the conditional expectation based on weighted averages. The coefficients of the included independent variables therefore would be biased and inconsistent. For z-value of -1.33: Use the row headed 1.3 and the column headed 3 to find the value 0.9082.

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