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Extreme events

*Robust Portfolio Construction
in the Presence of Fat Tails*

MALCOLM KEMP

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Presence of Fat Tails*

Malcolm H. D. Kemp



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Preface

There are two reasons for writing this book. The first is timing. This book has been written during a worldwide credit and economic crisis. The crisis has reminded us that extreme events can occur more frequently than we might like. It followed an extended period of relative stability and economic growth that, with hindsight, was the calm before a storm. Throughout this book, this crisis is referred to as the '2007–09 credit crisis'.

During the preceding relatively stable times, people had, maybe, paid less attention than they should have to the possibility of extreme events occurring. Perhaps you were one of them. Perhaps I was too. Adversity is always a good spur to careful articulation of underlying reality.

Extreme events were evident even right at the start of the 2007–09 credit crisis, at the end of July 2007 and in the first two weeks of August 2007. This marked the time when previously ruling relationships between interbank money market rates for different deposit terms first started to unravel. It also coincided with some sudden and unexpectedly large losses being incurred by some high profile (quantitatively run) hedge funds that unwound some of their positions when banks cut funding and liquidity lines to them. Other investors suffered unusually large losses on positions they held that had similar economic sensitivities to the ones that these hedge funds were liquidating.

During 2007 investors were also becoming more wary of US sub-prime debt. But, even as late as April 2008, central banks were still expecting markets gradually to regain their poise. It was not to be. In late 2008 the credit crisis erupted into a full-blown global banking crisis with the collapse of Lehman Brothers, the need for Western governments to shore up their banking systems and economies across the globe entering recessions. Market volatility during these troubled times was exceptional, reaching levels not seen since the Great Depression in the early 1930s. Extreme events had well and truly returned to the financial landscape.

The second reason for writing this book is that it naturally follows on from my earlier book on *Market Consistency*; see Kemp (2009). Market consistency was defined there as the activity of taking account of 'what the market has to say' in financial practice. In *Market Consistency* I argued that portfolio construction should be viewed as the third strand in a single overarching branch of financial theory and practice, the other two strands being valuation methodology and risk management processes. However, I also noted that the application of market consistency to portfolio construction was in some sense simultaneously both core and peripheral. It was 'core', in the sense that ultimately there is little point in merely valuing and measuring positions or risk; the focus should also be on managing them. It was also 'peripheral', because portfolio management generally also involves taking views about when the market is right and when it

is wrong, and then acting accordingly, i.e., it necessarily does not always agree with ‘what the market has to say’.

These different drivers meant that *Market Consistency* naturally focused more on valuation methodology and risk management and less on portfolio construction. So, this book seeks to balance the exposition in *Market Consistency* by exploring in more depth the portfolio construction problem. It is particularly aimed at those practitioners, students and others who, like me, find portfolio construction a fascinating topic to study or a useful discipline to apply in practice.

The style I have adopted when writing this book is similar to the one used for *Market Consistency*. This involves aiming simultaneously to write both a discursive text and a reference book. Readers will no doubt want a reference book to help them navigate through the many techniques that can be applied to portfolio construction. However, undue focus on the ‘how to’ rather than also on the ‘why should I want to’ or ‘what are the strengths and weaknesses of doing so’ is typically not the right way to help people in practice. Instead, readers ideally also expect authors to express opinions about the intrinsic usefulness of different techniques.

As in *Market Consistency* I have tried to find a suitable balance between mathematical depth and readability, to avoid some readers being overly daunted by unduly complicated mathematics. The book focuses on core principles and on illuminating them where appropriate with suitably pitched mathematics. Readers wanting a more detailed articulation of the underlying mathematics are directed towards the portfolio construction pages of the www.nematrian.com website, referred to throughout this book as Kemp (2010). Kemp (2010) also makes available a wide range of online tools that, inter alia, can be applied to the portfolio construction problem. Most of the charts in this book and the analyses on which they are based use these tools, and where copyrighted are reproduced with kind permission from Nematrian Limited. A few of the charts and principles quoted in this book are copied from ones already contained in *Market Consistency* and are reproduced with permission from John Wiley & Sons, Ltd.

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However, while I am very grateful for the support I have received from various sources when writing this book, I still take sole responsibility for any errors and omissions that it contains.

Abbreviations

ALM	asset-liability management
APT	Arbitrage Pricing Theory
AR	autoregressive
ARMA	autoregressive moving average
BL	Black-Litterman
bp	basis point
CAPM	Capital Asset Pricing Model
CDO	collateralised debt obligation
cdf	cumulative distribution function
CDS	credit default swap
CML	capital market line
COSO	Committee of Sponsoring Organisations of the Treadway Commission
CPPI	constant proportional portfolio insurance
CRO	chief risk officer
CRRA	constant relative risk aversion
CVaR	conditional Value-at-Risk (aka TVaR and Expected Shortfall)
EM	expectation-maximisation algorithm
EMH	efficient markets hypothesis
ERM	enterprise risk management
ESG	economic scenario generator
EU	European Union
EVD	extreme value distribution
EVT	extreme value theory
FOC	first order conditions
FSA	Financial Services Authority (UK)
GAAP	Generally Accepted Accounting Principles
GMM	Gaussian (i.e., multivariate Normal) mixture models
GRS F -test	Gibbons, Ross and Shanken (<i>Econometrica</i> 1989) F -test
HHI	Herfindahl Hirshman Index
i.i.d.	independent and identically distributed
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICA	independent components analysis

IT	information technology
lpm	lower partial moment
LTCM	Long Term Capital Management
MA	moving average
MCMC	Markov chain Monte Carlo
MDA	maximum domain of attraction
MRP	minimum risk portfolio
OLS	ordinary least squares
ORSA	Own Risk and Solvency Assessment
OSLL	out-of-sample log-likelihood
PCA	principal components analysis
pdf	probability density function
QQ	quantile–quantile
RE	resampled efficiency
RS	regime switching
S&Ls	(US) savings and loans associations
SCR	Solvency Capital Requirement
SETAR	self-exciting threshold autoregressive
SIV	structured investment vehicle
SYSC	Senior Management Arrangements, Systems and Controls
TAR	threshold autoregressive
TVaR	tail Value-at-Risk (aka CVaR and Expected Shortfall)
UK	United Kingdom of Great Britain and Northern Ireland
US and USA	United States of America
VaR	Value-at-Risk

Notation

$\mathbf{0}$ = vector of zeros

$\mathbf{1}$ = vector of ones

a , \mathbf{a} = active positions, (linear combination) signal mixing coefficients

$\hat{\alpha}$ = tail index parameter estimate

b , \mathbf{b} = benchmark, minimum risk portfolio, (distributional mixture) mixing coefficients

β = portfolio or individual security beta

γ , γ_i = cumulant of a distribution (if $i = 1$ then skew and if $i = 2$ then ‘excess’ kurtosis)

Γ_0 = option gamma

Δ = amount to invest in the underlying in a hedging algorithm

Δ_0 = option delta

E = analogue of energy in simulated annealing algorithm

$E(X)$ = expected value of X

$E(X|\theta)$ = expected value of X given θ

$\varepsilon_{j,t}$ = error terms in a regression analysis

$f(x)$ = probability density function

$F(x)$, $F^{-1}(x)$ = cumulative distribution function (or more generally some specified distributional form) and its inverse function

$\langle f \rangle$ = Monte Carlo estimate of the average of a function f

$\langle\langle f \rangle\rangle$ = true average of a function f

h = time period length

i, j, k = counting indexes

I, \mathbf{I} = Identity matrix

I_t = index series

$I_\alpha(t)$ = ‘hit’ series when backtesting

K = option strike price

L = lottery, Lagrange multiplier

λ = risk-reward trade-off parameter, also eigenvalue

m = number of assets (or liabilities, or both) in the portfolio optimisation problem

μ , $\boldsymbol{\mu}$, $\hat{\boldsymbol{\mu}}$ = mean of a univariate distribution, vector of population means of a multivariate distribution, vector of sample or estimated means (likewise use of ‘hat’ symbol for other variables)

n = number of time periods, observations or simulations

$N(z)$, $N^{-1}(z)$ = cumulative distribution function for the Normal distribution, and its inverse function

$o(x)$ = tends to zero more rapidly than x as $x \rightarrow 0$

$O(n)$ = of order (magnitude) a constant times n (in analysis of algorithm run times)

$p(X)$ = probability of X occurring

$P(X \leq x)$ = probability that a random variable X is less than some value x

$p(X|\theta)$, $P(X|\theta)$ = probability of X given θ

r = return on an asset, liability or index

\bar{r} = mean of r

r_{rf} , r_b = risk-free rate of return, benchmark return

ρ = correlation coefficient, risk measure

s = stress test, regime

S = spectrum of an autoregressive time series

S_t = stock index series

$S(\alpha, \beta, \gamma, \delta_k; k)$ = Stable distribution with parameters $(\alpha, \beta, \gamma, \delta_k)$ using parameter definition k ($= 0$ or 1)

σ = standard deviation

T = matrix transpose (if used as a superscript), also (when not confusing) time at end of analysis/time horizon, also analogue of temperature in simulated annealing algorithm

$T(z)$ = transfer function

V = a volume in a multi-dimensional space

\mathbf{V} = covariance matrix

w_i , w_t , \mathbf{w}_t , $w_{i,j}$ = weight in asset i , innovation at time t (possibly expressed in vector form for vector autoregressive series), elements of mixing matrix W

W = mixing matrix, terminal wealth

$X_n \stackrel{\Delta}{=} X$ = equality in distributional form

$Z_n \xrightarrow{D} F$ = the sequence of random variables, Z_n , converges in distribution to F as $n \rightarrow \infty$, i.e., in the limit takes the distributional form characterised by F

Contents

Preface	xv
Acknowledgements	xvii
Abbreviations	xix
Notation	xxi
1 Introduction	1
1.1 Extreme events	1
1.2 The portfolio construction problem	2
1.3 Coping with really extreme events	2
1.4 Risk budgeting	3
1.5 Elements designed to maximise benefit to readers	4
1.6 Book structure	4
2 Fat Tails – In Single (i.e., Univariate) Return Series	7
2.1 Introduction	7
2.2 A fat tail relative to what?	7
2.3 Empirical examples of fat-tailed behaviour in return series	11
2.3.1 Introduction	11
2.3.2 Visualising fat tails	11
2.3.3 Behaviour of individual bonds and bond indices	17
2.3.4 Behaviour of equity indices	17
2.3.5 Currencies and other asset types	22
2.4 Characterising fat-tailed distributions by their moments	23
2.4.1 Introduction	23
2.4.2 Skew and kurtosis	25
2.4.3 The (fourth-moment) Cornish-Fisher approach	26
2.4.4 Weaknesses of the Cornish-Fisher approach	27
2.4.5 Improving on the Cornish-Fisher approach	28
2.4.6 Statistical tests for non-Normality	29
2.4.7 Higher order moments and the Omega function	31

2.5	What causes fat tails?	32
2.5.1	Introduction	32
2.5.2	The Central Limit Theorem	33
2.5.3	Ways in which the Central Limit Theorem can break down	34
2.6	Lack of diversification	35
2.7	A time-varying world	36
2.7.1	Introduction	36
2.7.2	Distributional mixtures	37
2.7.3	Time-varying volatility	38
2.7.4	Regime shifts	40
2.8	Stable distributions	41
2.8.1	Introduction	41
2.8.2	Defining characteristics	42
2.8.3	The Generalised Central Limit Theorem	44
2.8.4	Quantile–quantile plots of stable distributions	45
2.9	Extreme value theory (EVT)	45
2.9.1	Introduction	45
2.9.2	Extreme value distributions	46
2.9.3	Tail probability densities	47
2.9.4	Estimation of and inference from tail index values	47
2.9.5	Issues with extreme value theory	47
2.10	Parsimony	50
2.11	Combining different possible source mechanisms	52
2.12	The practitioner perspective	53
2.12.1	Introduction	53
2.12.2	Time-varying volatility	53
2.12.3	Crowded trades	53
2.12.4	Liquidity risk	54
2.12.5	‘Rational’ behaviour versus ‘bounded rational’ behaviour	54
2.12.6	Our own contribution to the picture	55
2.13	Implementation challenges	55
2.13.1	Introduction	55
2.13.2	Smoothing of return series	56
2.13.3	Time clocks and non-constant time period lengths	57
2.13.4	Price or other data rather than return data	58
2.13.5	Economic sensitivities that change through time	58
3	Fat Tails – In Joint (i.e., Multivariate) Return Series	61
3.1	Introduction	61
3.2	Visualisation of fat tails in multiple return series	61
3.3	Copulas and marginals – Sklar’s theorem	64
3.3.1	Introduction	64
3.3.2	Fractile–fractile (i.e., quantile–quantile box) plots	66
3.3.3	Time-varying volatility	72
3.4	Example analytical copulas	75
3.4.1	Introduction	75
3.4.2	The Gaussian copula	76

3.4.3	The t -copula	76
3.4.4	Archimedean copulas	78
3.5	Empirical estimation of fat tails in joint return series	78
3.5.1	Introduction	78
3.5.2	Disadvantages of empirically fitting the copula	79
3.5.3	Multi-dimensional quantile–quantile plots	80
3.6	Causal dependency models	83
3.7	The practitioner perspective	83
3.8	Implementation challenges	85
3.8.1	Introduction	85
3.8.2	Series of different lengths	85
3.8.3	Non-coincidentally timed series	86
3.8.4	Cluster analysis	87
3.8.5	Relative entropy and nonlinear cluster analysis	88
4	Identifying Factors That Significantly Influence Markets	91
4.1	Introduction	91
4.2	Portfolio risk models	92
4.2.1	Introduction	92
4.2.2	Fundamental models	94
4.2.3	Econometric models	95
4.2.4	Statistical risk models	96
4.2.5	Similarities and differences between risk models	96
4.3	Signal extraction and principal components analysis	97
4.3.1	Introduction	97
4.3.2	Principal components analysis	99
4.3.3	The theory behind principal components analysis	100
4.3.4	Weighting schemas	102
4.3.5	Idiosyncratic risk	103
4.3.6	Random matrix theory	103
4.3.7	Identifying principal components one at a time	106
4.4	Independent components analysis	106
4.4.1	Introduction	106
4.4.2	Practical algorithms	107
4.4.3	Non-Normality and projection pursuit	109
4.4.4	Truncating the answers	110
4.4.5	Extracting all the un-mixing weights at the same time	110
4.4.6	Complexity pursuit	111
4.4.7	Gradient ascent	112
4.5	Blending together principal components analysis and independent components analysis	112
4.5.1	Introduction	112
4.5.2	Including both variance and kurtosis in the importance criterion	113
4.5.3	Eliminating signals from the remaining dataset	114
4.5.4	Normalising signal strength	115
4.6	The potential importance of selection effects	116
4.6.1	Introduction	116

4.6.2	Quantifying the possible impact of selection effects	116
4.6.3	Decomposition of fat-tailed behaviour	119
4.7	Market dynamics	120
4.7.1	Introduction	120
4.7.2	Linear regression	120
4.7.3	Difference equations	121
4.7.4	The potential range of behaviours of linear difference equations	122
4.7.5	Multivariate linear regression	124
4.7.6	'Chaotic' market dynamics	125
4.7.7	Modelling market dynamics using nonlinear methods	127
4.7.8	Locally linear time series analysis	128
4.8	Distributional mixtures	129
4.8.1	Introduction	129
4.8.2	Gaussian mixture models and the expectation-maximisation algorithm	129
4.8.3	k -means clustering	131
4.8.4	Generalised distributional mixture models	132
4.8.5	Regime shifts	132
4.9	The practitioner perspective	133
4.10	Implementation challenges	134
4.10.1	Introduction	134
4.10.2	Local extrema	135
4.10.3	Global extrema	136
4.10.4	Simulated annealing and genetic portfolio optimisation	137
4.10.5	Minimisation/maximisation algorithms	138
4.10.6	Run time constraints	138
5	Traditional Portfolio Construction Techniques	141
5.1	Introduction	141
5.2	Quantitative versus qualitative approaches?	141
5.2.1	Introduction	141
5.2.2	Viewing any process through the window of portfolio optimisation	142
5.2.3	Quantitative versus qualitative insights	143
5.2.4	The characteristics of pricing/return anomalies	144
5.3	Risk-return optimisation	145
5.3.1	Introduction	145
5.3.2	Mean-variance optimisation	146
5.3.3	Formal mathematical notation	148
5.3.4	The Capital Asset Pricing Model (CAPM)	149
5.3.5	Alternative models of systematic risk	152
5.4	More general features of mean-variance optimisation	152
5.4.1	Introduction	152
5.4.2	Monotonic changes to risk or return measures	152
5.4.3	Constraint-less mean-variance optimisation	153
5.4.4	Alpha-beta separation	153

5.4.5	The importance of choice of universe	154
5.4.6	Dual benchmarks	154
5.5	Manager selection	154
5.6	Dynamic optimisation	156
5.6.1	Introduction	156
5.6.2	Portfolio insurance	157
5.6.3	Stochastic optimal control and stochastic programming techniques	157
5.7	Portfolio construction in the presence of transaction costs	158
5.7.1	Introduction	158
5.7.2	Different types of transaction costs	158
5.7.3	Impact of transaction costs on portfolio construction	159
5.7.4	Taxes	160
5.8	Risk budgeting	161
5.8.1	Introduction	161
5.8.2	Information ratios	162
5.9	Backtesting portfolio construction techniques	163
5.9.1	Introduction	163
5.9.2	Different backtest statistics for risk-reward trade-offs	164
5.9.3	In-sample versus out-of-sample backtesting	166
5.9.4	Backtesting risk models	167
5.9.5	Backtesting risk-return models	169
5.9.6	Transaction costs	169
5.10	Reverse optimisation and implied view analysis	170
5.10.1	Implied alphas	170
5.10.2	Consistent implementation of investment ideas across portfolios	171
5.11	Portfolio optimisation with options	171
5.12	The practitioner perspective	173
5.13	Implementation challenges	174
5.13.1	Introduction	174
5.13.2	Optimisation algorithms	174
5.13.3	Sensitivity to the universe from which ideas are drawn	175
6	Robust Mean-Variance Portfolio Construction	177
6.1	Introduction	177
6.2	Sensitivity to the input assumptions	178
6.2.1	Introduction	178
6.2.2	Estimation error	180
6.2.3	Mitigating estimation error in the covariance matrix	181
6.2.4	Exact error estimates	182
6.2.5	Monte Carlo error estimation	185
6.2.6	Sensitivity to the structure of the smaller principal components	186
6.3	Certainty equivalence, credibility weighting and Bayesian statistics	187
6.3.1	Introduction	187
6.3.2	Bayesian statistics	188
6.3.3	Applying Bayesian statistics in practice	189

6.4	Traditional robust portfolio construction approaches	190
6.4.1	Introduction	190
6.4.2	The Black-Litterman approach	191
6.4.3	Applying the Black-Litterman approach in practice	192
6.4.4	Opinion pooling	193
6.4.5	Impact of non-Normality when using more complex risk measures	193
6.4.6	Using the Herfindahl Hirshman Index (HHI)	194
6.5	Shrinkage	194
6.5.1	Introduction	194
6.5.2	'Shrinking' the sample means	194
6.5.3	'Shrinking' the covariance matrix	196
6.6	Bayesian approaches applied to position sizes	197
6.6.1	Introduction	197
6.6.2	The mathematics	198
6.7	The 'universality' of Bayesian approaches	200
6.8	Market consistent portfolio construction	201
6.9	Resampled mean-variance portfolio optimisation	202
6.9.1	Introduction	202
6.9.2	Different types of resampling	203
6.9.3	Monte Carlo resampling	203
6.9.4	Monte Carlo resampled optimisation <i>without</i> portfolio constraints	206
6.9.5	Monte Carlo resampled optimisation <i>with</i> portfolio constraints	207
6.9.6	Bootstrapped resampled efficiency	208
6.9.7	What happens to the smaller principal components?	208
6.10	The practitioner perspective	208
6.11	Implementation challenges	210
6.11.1	Introduction	210
6.11.2	Monte Carlo simulation – changing variables and importance sampling	211
6.11.3	Monte Carlo simulation – stratified sampling	212
6.11.4	Monte Carlo simulation – quasi (i.e., sub-) random sequences	213
6.11.5	Weighted Monte Carlo	214
6.11.6	Monte Carlo simulation of fat tails	214
7	Regime Switching and Time-Varying Risk and Return Parameters	217
7.1	Introduction	217
7.2	Regime switching	217
7.2.1	Introduction	217
7.2.2	An example of regime switching model	218
7.2.3	The operation of regime switching model	219
7.2.4	Complications	220
7.3	Investor utilities	221
7.3.1	Introduction	221
7.3.2	Expected utility theory	222
7.3.3	Constant relative risk aversion (CRRA)	223
7.3.4	The need for monetary value to be well defined	224

7.4	Optimal portfolio allocations for regime switching models	226
7.4.1	Introduction	226
7.4.2	Specification of problem	226
7.4.3	General form of solution	227
7.4.4	Introducing regime switching	227
7.4.5	Dependency on ability to identify prevailing regime	228
7.4.6	Identifying optimal asset mixes	229
7.4.7	Incorporating constraints on efficient portfolios	229
7.4.8	Applying statistical tests to the optimal portfolios	230
7.4.9	General form of RS optimal portfolio behaviour	230
7.5	Links with derivative pricing theory	231
7.6	Transaction costs	232
7.7	Incorporating more complex autoregressive behaviour	234
7.7.1	Introduction	234
7.7.2	Dependency on periods earlier than the latest one	235
7.7.3	Threshold autoregressive models	235
7.7.4	'Nearest neighbour' approaches	236
7.8	Incorporating more intrinsically fat-tailed behaviour	236
7.9	More heuristic ways of handling fat tails	237
7.9.1	Introduction	237
7.9.2	Straightforward ways of adjusting for time-varying volatility	237
7.9.3	Lower partial moments	238
7.10	The practitioner perspective	240
7.11	Implementation challenges	241
7.11.1	Introduction	241
7.11.2	Solving problems with time-varying parameters	241
7.11.3	Solving problems that have derivative-like elements	242
7.11.4	Catering for transaction costs and liquidity risk	242
7.11.5	Need for coherent risk measures	243
8	Stress Testing	245
8.1	Introduction	245
8.2	Limitations of current stress testing methodologies	246
8.3	Traditional stress testing approaches	247
8.3.1	Introduction	247
8.3.2	Impact on portfolio of 'plausible' but unlikely market scenarios	248
8.3.3	Use for standardised regulatory capital computations	248
8.3.4	A greater focus on what might lead to large losses	250
8.3.5	Further comments	251
8.4	Reverse stress testing	252
8.5	Taking due account of stress tests in portfolio construction	253
8.5.1	Introduction	253
8.5.2	Under-appreciated risks	253
8.5.3	Idiosyncratic risk	253
8.5.4	Key exposures	254
8.6	Designing stress tests statistically	255
8.7	The practitioner perspective	257