

Contents

1. Financial markets as complex systems	1
1.1 Real problems in finance	1
1.2 Complex systems and complexity	3
1.3 Financial market overview	4
1.4 Observing the market	16
2. Standard finance theory	19
2.1 The problem for standard finance theory	19
2.2 Taking a random walk	20
2.3 Risk: tails of the unexpected	42
2.4 Eliminating risk within the Black–Scholes option pricing theory	44
3. A complex walk down Wall Street	55
3.1 Facing the stylized facts	55
3.2 Statistical tools and datasets	57
3.3 Empirical analysis	58
3.4 Challenging the standard theory	69
3.5 Towards a general stochastic process framework	71
3.6 Effects of temporal correlations in a market	73
4. Financial market models with global interactions	81
4.1 A bottom-up approach	81
4.2 Two's company, but three's a crowd	83
4.3 'To bar, or not to bar . . .'	87
4.4 From the bar to the market	88
4.5 Choosing a model	108
4.6 The 'El Farol Market Model'	109

4.7	Dynamics of the ‘El Farol Market Model’	115
4.8	Statics of the ‘El Farol Market Model’: the origins of volatility	116
5.	Financial market models with local interactions	137
5.1	Clustering and herd behaviour	137
5.2	Transmission of information: the EZ model	140
5.3	Analytic model: generating function approach	144
5.4	The percolation problem	149
5.5	Cont–Bouchaud model on a lattice	150
5.6	Variations on a theme	151
5.7	Modified EZ models	153
5.8	Other microscopic market models	156
6.	Non-zero risk in the real world	161
6.1	The other side of derivatives	161
6.2	Hedging to reduce risk	163
6.3	Zero risk?	164
6.4	Pricing and hedging with real-world asset movements	165
6.5	Generalizing the formalism	202
7.	Deterministic dynamics, chaos, and crashes	223
7.1	Living with non-linearity	223
7.2	Non-linear dynamical models for finance and economics	226
7.3	Financial crashes and drawdowns	239
7.4	Predicting the future: who wants to be a Millionaire?	250
	Further reading	252
	Index	253