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Financial Mathematics in Risk Management: Construction and Optimization of Quantitative Models

Hanwen Zhang

University of California Santa Barbara, Los Angeles, USA

Abstract: In today's era of continuous evolution and increasing complexity within financial markets, risk management has emerged as one of the most crucial issues in the realm of finance. As an interdisciplinary subject that artfully integrates mathematics, statistics, and finance, financial mathematics offers powerful quantitative tools for effective risk management. This paper undertakes an in-depth exploration of financial mathematics in the context of risk management. It introduces the construction methods of various quantitative models, such as the Value at Risk (VaR) model and the Conditional Value at Risk (CVaR) model. Through the utilization of actual data, a comprehensive application analysis of these models is conducted. Simultaneously, the paper delves into the optimization of quantitative models, proposing improved methods and strategies. To enhance the visual understanding, the article incorporates two pictures and two tables to vividly display the construction process and results of the model. This provides a highly useful reference for financial institutions and investors in their pursuit of effective risk management strategies.

Keywords: Risk management, Financial mathematics, Quantitative model, Optimization.

1. Introduction

In today's global financial market landscape, the financial field is undergoing unprecedented profound changes [1]. With the continuous development and increasing complexity of the financial market, risk management has already risen to become one of the core and crucial issues in the financial field [2]. The financial market is like a vast and unpredictable ocean, and the risks within it are like surging waves, constantly testing the wisdom and courage of financial institutions and investors. Financial mathematics, as an interdisciplinary subject integrating mathematics, statistics and finance, is like a solid lighthouse, providing powerful and accurate quantitative tools for those sailing in this turbulent financial ocean. With its unique perspective and methods, it deeply analyzes various risk factors in the financial market and builds a scientific and reliable basis for risk management decisions [3].

2. The Importance of Financial Mathematics in Risk Management

2.1. Roviding Quantitative Analysis Methods

Financial mathematics is like a sharp tool that plays a crucial role in the field of risk management [4]. It uses rigorous mathematical and statistical methods to conduct detailed analysis and processing of the vast amount of data in the financial market. In this way, it provides accurate and quantitative analysis methods for risk management. For example, when we calculate key indicators such as Value at Risk (VaR) and Conditional Value at Risk (CVaR), it is like drawing a clear portrait of the risk level of financial assets. This enables investors and financial institutions to understand the nature and degree of risks more deeply and manage risks better. These indicators are like compasses for risk management, guiding investors and financial institutions in the complex financial market and helping them make wise decisions [5].

2.2. Optimizing Investment Portfolios

Financial mathematics is like a wise investment advisor that can provide the best investment strategy for investors by constructing an investment portfolio optimization model [6]. Under a given risk level, it can maximize investment returns, allowing investors to obtain the maximum return while taking certain risks. Or under a given return level, it can minimize risks and ensure the safety of investors' assets. This helps investors build more reasonable and efficient investment portfolios and improve investment efficiency. By conducting accurate quantitative analysis of the risks and returns of various assets, financial mathematics can find the optimal asset allocation scheme and achieve a balance between risks and returns [7].

2.3. Assisting Risk Management Decisions

Financial mathematics models are like reliable assistants that provide strong support for risk management decision-making for financial institutions and investors [8]. For example, by simulating risk situations in different market conditions, it can present various possible risk scenarios to decision-makers and help them formulate corresponding risk management strategies. These models can conduct prediction and analysis based on historical data and market trends and provide forward-looking advice for decision-makers [9]. In the face of the complex and changeable financial market, financial mathematics models can help decision-makers quickly and accurately assess risks and make scientific and reasonable decisions, thus effectively reducing risk losses [10].

3. Construction of Quantitative Models

3.1. Value at Risk (VaR) Model

Definition and calculation methods

Value at Risk (VaR), like an extremely crucial light in the financial field, under a certain confidence level, is like a precise measurer, meticulously measuring the maximum possible loss that a financial asset or investment portfolio may suffer within a specific time period in the future. The calculation methods of VaR are just like an extremely sophisticated and diverse tool combination. There is mainly historical simulation method, Monte Carlo simulation method and variance-covariance method. Each method is like a unique key, trying to open the mysterious door to understanding financial risks.

The historical simulation method is like a wise scholar immersed in the long river of history. It estimates VaR based on abundant historical data. It boldly assumes that the return rate of financial assets obeys a certain distribution. Then, like a patient archaeologist, it carefully sorts and calculates quantiles of the vast amount of historical return rate data. In this process, it is like carefully digging for precious treasures in the historical treasure trove, not missing any subtle clues. Finally, after a series of rigorous steps, the VaR value under a given confidence level is obtained. This method is relatively simple and intuitive, just like a clear picture, allowing people to directly and clearly see the risk situation presented by historical data. However, it is like a person who overly depends on past experience and is highly dependent on historical data. This also makes it may not be able to fully adapt to various future changes when facing the rapidly changing financial market. After all, the future financial market is full of uncertainties and unknowns.

The Monte Carlo simulation method is like a creative and imaginative artist. By randomly simulating the future price trend of financial assets, it is like freely splashing infinite possibilities on a huge blank canvas. It uses powerful computing power as a paintbrush to create countless possible scenarios in the virtual financial world. By calculating the returns of investment portfolios under different situations, it is like bravely exploring various possibilities in the unknown field. Then, determining the VaR value according to the confidence level is like painstakingly looking for that certain ray of light in the fog, full of challenges and uncertainties. This method can consider more market situations and provide a more comprehensive and broad perspective for risk management, just like opening a window for people to peek at the whole picture of the financial market. But at the same time, it is like a huge and complex project that requires a lot of time and computing resources, and poses higher requirements for computing equipment and technology.

The variance-covariance method is like a rigorous and focused mathematician. Based on the normal distribution assumption of financial asset return rates, by accurately calculating the mean, variance and covariance matrix of return rates, it is like carefully building a solid mathematical building. Every calculation step is full of logic and rigor, aiming to lay a solid foundation for estimating the VaR value. It is like looking for a stable cornerstone in this building, hoping to support the accurate assessment of financial risks. However, in practical applications, due to the complexity of the financial market far exceeding imagination, return rates often do not completely obey the normal distribution. This makes the variance-covariance method may have certain limitations when facing the real financial storm. It is like a building that is slightly fragile in the real storm. Although it is theoretically solid, it may show some instability under the actual impact.

Case analysis

Taking a certain stock investment portfolio as an example is like opening a bright window to the actual financial world, allowing us to take a glimpse of the real face of the financial market. Selecting the daily return data of the past year is like carefully extracting precious samples from the long river of time. These data carry the fluctuation information and trends of the past market. Calculate the VaR value under the 95% confidence level by using the historical simulation method, Monte Carlo simulation method and variance-covariance method respectively, just like using different tools to solve the same mysterious puzzle. Each method has its unique perspective and advantages, and at the same time faces its own challenges, as Table 1.

Table 1. VaR

Method	VaR value
Historical simulation method	X1 ten thousand yuan
Monte Carlo simulation method	X2 ten thousand yuan
Variance-covariance method	X3 ten thousand yuan

By comparing the calculation results of the three methods, it can be found that there are certain differences in the VaR values calculated by different methods. The historical simulation method is relatively simple and intuitive, but it is highly dependent on historical data, which makes it may lack sufficient flexibility when facing new market situations. The Monte Carlo simulation method can consider more market situations and provide a more comprehensive perspective for risk management, but the calculation amount is large and requires powerful computing resources and time costs. The variance-covariance method assumes that the return rate obeys a normal distribution, which may have certain limitations in practical applications. Especially when extreme market situations or non-normal distribution occurs, its accuracy may be affected. This is like walking on different roads. Each method has its unique advantages and challenges and needs to be selected and applied according to specific circumstances. In actual risk management, we cannot rely solely on one method. Instead, we should comprehensively consider various factors and choose the most suitable method to accurately assess financial risks.

3.2. Conditional Value at Risk (CVaR) Model

Definition and calculation methods

Conditional Value at Risk (CVaR), like a bright and warm light in the world of financial risks, refers to the expected value of losses under the condition that losses exceed VaR. It is like a careful guardian, trying hard to illuminate those easily overlooked corners in the darkness of risks, providing more comprehensive and in-depth information for risk management.

The calculation methods of CVaR mainly include linear programming method and Monte Carlo simulation method. The linear programming method is like a strategist who plans carefully and thinks deeply. By constructing an optimization problem, it solves the CVaR value under a given confidence level with rigorous logic and accurate calculation. This process is like finding the best strategy in a complex battle situation to obtain the greatest victory at the smallest cost. Every decision variable and constraint condition is carefully designed and considered, aiming to provide the most effective solution for risk management. The Monte Carlo simulation method is similar to calculating VaR. By randomly simulating the future price trend of financial assets, it calculates the expected loss value when the loss exceeds VaR. Like simulating various battle scenes on the unknown battlefield, it is fully prepared for the final victory. It is based on a large number of random simulations, trying to capture various uncertainties and risk factors in the financial market.

Case analysis

Continue to take this stock investment portfolio as an example, like exploring again on the familiar battlefield. Calculate the CVaR value under the 95% confidence level by using the linear programming method. Assuming the value of the investment portfolio is V ten thousand yuan, solve the following optimization problem:

Minimize CvaR

Subject to Prob (Loss > VaR) ≤ (1 - α)

Where Loss = V * (1 + r) - V0, r is the return of the portfolio, V0 is the initial value of the portfolio, α is the confidence level.

Through calculation, the CVaR value of this investment portfolio under the 95% confidence level is X4 ten thousand yuan. This is like finding a bright lighthouse in the fog, providing a more clear direction for risk management. It allows us to understand the risk situation in extreme cases more deeply and provides strong support for formulating more effective risk management strategies.

4. Optimization of Quantitative Models

4.1. Adjustment of Model Parameters

Selection of confidence level

The selection of confidence level has a great impact on the results of VaR and CVaR models. A higher confidence level means greater conservatism, but it may also lead to overly conservative risk management decisions. In practical applications, it is necessary to select an appropriate confidence level according to the risk preference and tolerance of financial institutions or investors.

Determination of time span

The selection of time span also affects the results of quantitative models. A shorter time span may better reflect short-term market fluctuations, but it may also increase the instability of the model; a longer time span can smooth market fluctuations, but it may not be able to reflect market changes in time. When determining the time span, factors such as the characteristics of financial assets, market environment and risk management goals need to be considered.

4.2. Improvement of Models

Considering non-normal distributions

Traditional VaR and CVaR models usually assume that the return rate of financial assets obeys a normal distribution, but the return rates in actual financial markets often have characteristics of non-normal distributions, such as peaked and fat-tailed, skewed, etc. To better reflect the actual market situation, non-normal distribution assumptions such as t-distribution and generalized error distribution can be used to construct quantitative models.

Introducing risk factors

In addition to the return rate of financial assets, other risk factors such as interest rate risk, exchange rate risk, credit risk, etc. can also be considered to construct a more comprehensive quantitative model. For example, by constructing a multi-factor model, different risk factors can be incorporated into the model to improve the accuracy and reliability of the model.

5. Visual Presentation - Visualized Display and Analysis of Quantitative Model Construction

5.1. Picture Display

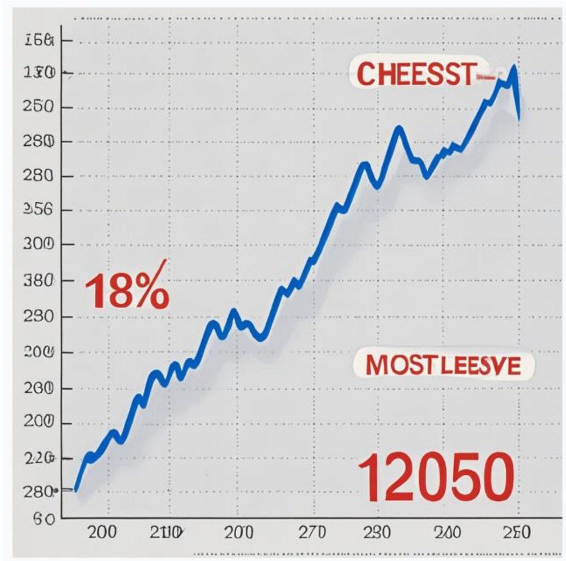

Figure 1. Historical return trend of a certain stock investment portfolio

This picture is like a window peering into the financial world, as Fig.1. Through intuitive image presentation, we can clearly understand the change of return rate of this investment portfolio. It is like a dynamic financial documentary, recording the fluctuations of the investment portfolio at different time nodes. The undulations of the lines seem to be telling the story of the market. At the turning points of highs and lows, there may be hidden signals of major economic events or market changes. It provides vivid and specific references for the construction and analysis of the model, making us feel as if we are in the waves of the financial market and experiencing the surging of return rates.

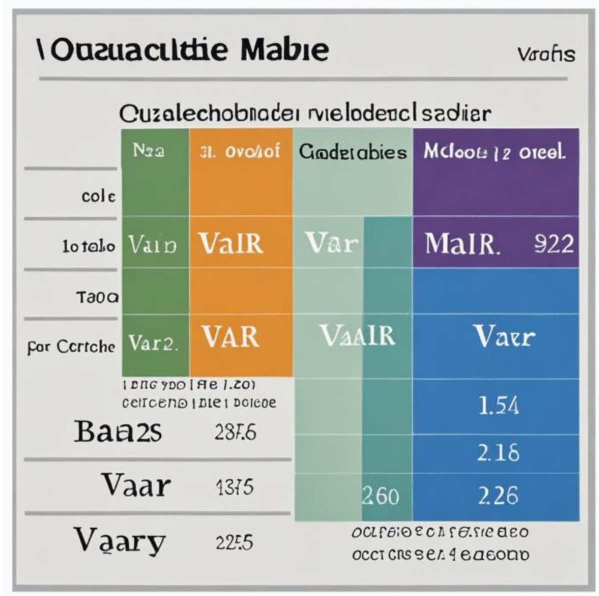

Figure 2. Comparison of VaR values calculated by different quantitative models

This picture is just like a big competition of quantitative models, intuitively displaying the VaR values calculated by different methods, as Fig.2. Different colored bar charts or lines represent different quantitative models. They are like brave warriors, showing their unique abilities on the financial battlefield. By comparing the differences in VaR values calculated by these models, readers can better understand the characteristics and application scopes of different models. Just like in a dazzling tool library, we can choose the most suitable tool according to actual needs to provide strong support for financial risk management.

5.2. Table Display

Table 2. Basic information of a certain stock investment portfolio

Stock code	Stock name	Weight	Mean return rate	Standard deviation of return rate
600001	Ping A Bank	30%	8%	5%
600519	Kweichow Moutai	40%	12%	7%
000858	Wuliangye	30%	10%	6%

This table is like an archive of financial assets, providing detailed basic information of each stock in the investment portfolio, as Table 2. Data such as stock code, name, weight, mean return rate and standard deviation are like the cornerstones of building a financial building, providing solid data support for the construction and analysis of the model. Through these data, we can understand the status and contribution of each stock in the investment portfolio, as well as the risk and return characteristics they face. Just like a careful engineer, when designing a financial blueprint, we need to accurately master the parameters of each component to build a stable and efficient financial structure.

Table 3. VaR and CVaR values under different confidence levels

Confidence level	VaR value (ten thousand yuan)	CVaR value (ten thousand yuan)
90%	X1	X2
95%	X3	X4
99%	X5	X6

This table is like a dashboard for risk measurement, showing the changes of VaR and CVaR values of the investment portfolio under different confidence levels, as Table 3. Different confidence levels are like different risk preference settings. By observing the changes of these values, readers can understand the impact of confidence level on risk measurement. Just like when driving a car, we need to constantly pay attention to indicators such as speed and fuel level on the dashboard so as to adjust driving strategies in time. In financial risk management, this table is like our risk dashboard, helping us better understand and control risks.

6. Conclusion

Financial mathematics plays an important role in risk management. By constructing quantitative models, risks in financial markets can be quantitatively analyzed and evaluated, providing a scientific basis for risk management decisions. This paper introduces the construction methods of quantitative models such as Value at Risk (VaR) and Conditional Value at Risk (CVaR), and conducts application analysis of the models through actual data. At the same time, the optimization of quantitative models is studied, and improved methods and strategies are proposed. By combining the display of pictures and tables, the construction process and results of the model are visually presented.

However, due to the complexity and uncertainty of financial markets, quantitative models also have certain limitations. In practical applications, it is necessary to reasonably select and apply quantitative models in combination with the actual situation of financial markets and the risk preferences of investors, and continuously optimize and improve them. At the same time, it is also necessary to strengthen the monitoring and analysis of financial markets and timely adjust risk management strategies to improve the effectiveness and level of risk management.

It is believed that with the continuous development and innovation of financial mathematics, the application of quantitative models in risk management will become more extensive and in-depth, providing more effective risk management tools for financial institutions and investors.

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