

Probablity

By
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Probability Vs Statistics

Probability Vs Statistics

- Probability – Predict the likelihood of a future event
- Statistics – Analyze the past events
- Probability – What will happen in a given ideal world?
- Statistics – How ideal is the world?

Probability Vs Statistics



Probability is the basis of
inferential statistics.

Probability - Applications

8 National Vital Statistics Reports, Vol. 54, No. 14, April 19, 2006

Table 1. Life table for the total population: United States, 2003

Age	Probability of dying between ages x to $x+1$	Number surviving to age x	Number dying between ages x to $x+1$
	$q(x)$	$l(x)$	$d(x)$
0-1	0.006865	100,000	687
1-2	0.000469	99,313	47
2-3	0.000337	99,267	33
3-4	0.000254	99,233	25
4-5	0.000194	99,208	19
5-6	0.000177	99,189	18
6-7	0.000160	99,171	16

Insurance industry uses probabilities in actuarial tables for setting premiums and coverages.

Assigning Probabilities

Classical Method – *A priori* or Theoretical

Probability can be determined prior to conducting any experiment.

$$P(E) = \frac{\text{\# of outcomes in which the event occurs}}{\text{total possible \# of outcomes}}$$

Example: Tossing of a fair die



Assigning Probabilities

Empirical Method – *A posteriori* or Frequentist

Probability can be determined post conducting a thought experiment.

$$P(E) = \frac{\text{\textit{\# of times an event occurred}}}{\text{\textit{total \# of opportunities for the event to have occurred}}}$$

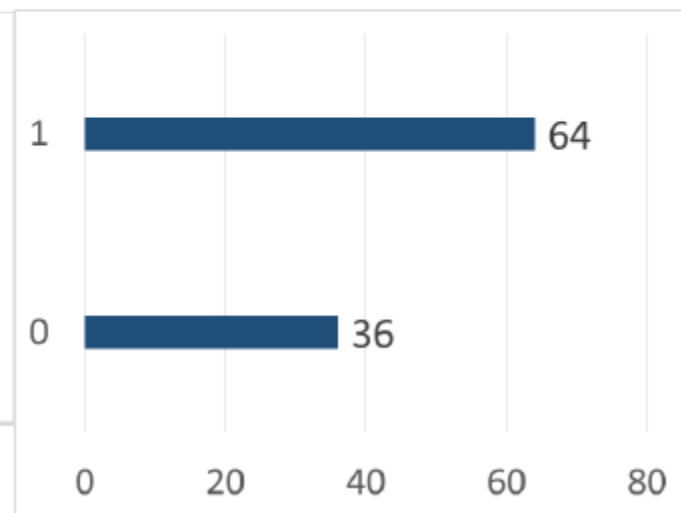
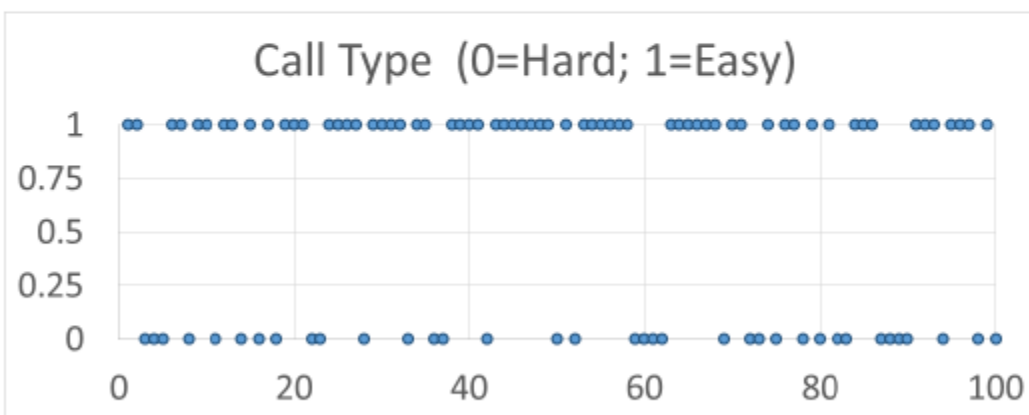
Example: Tossing of a weighted die...well!, even a fair die. The larger the number of experiments, the better the approximation.

This is the most used method in statistical inference.

Assigning Probabilities

Empirical Method – *A posteriori* or Frequentist

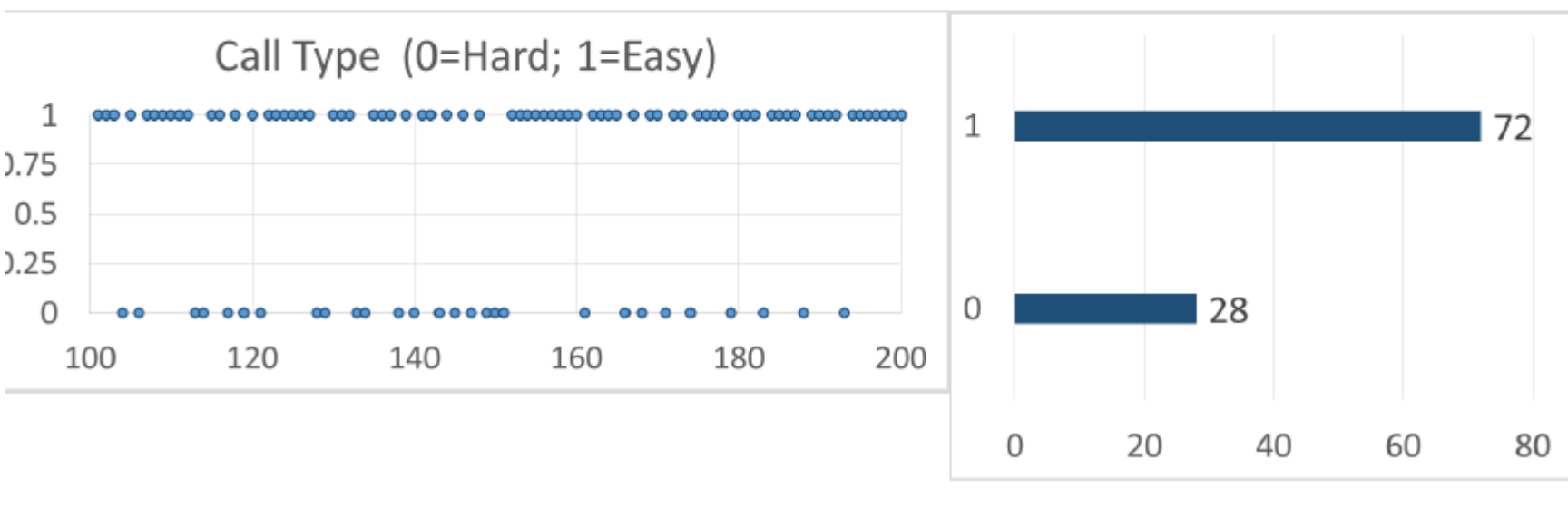
100 calls handled by an agent at a call centre



Assigning Probabilities

Empirical Method – *A posteriori* or Frequentist

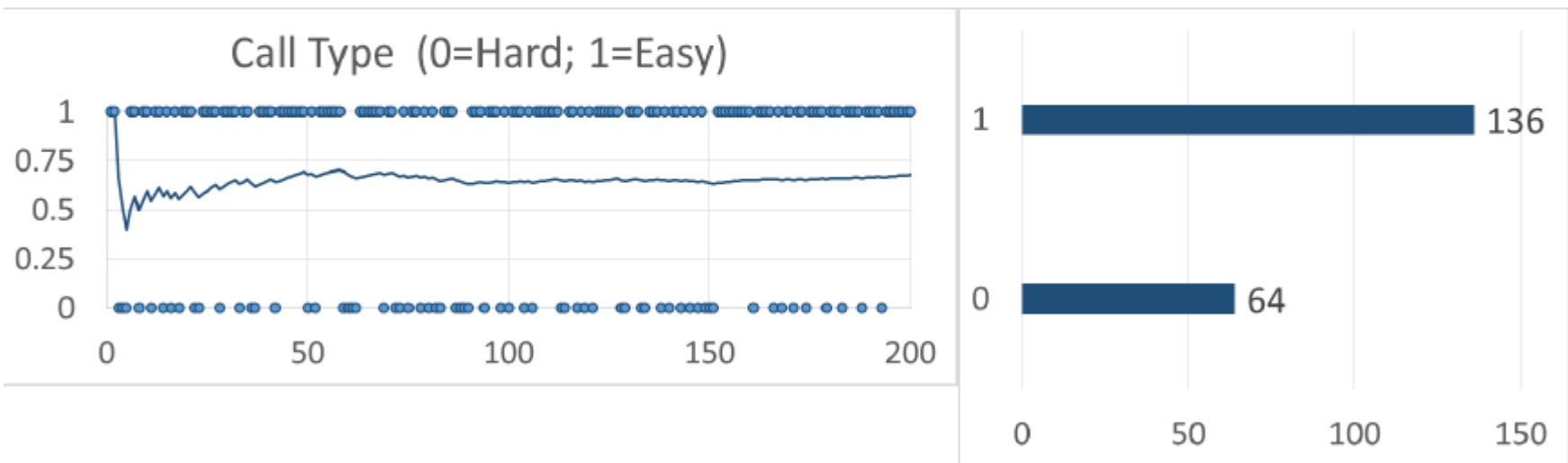
Next 100 calls handled by an agent at a call centre



Assigning Probabilities

Empirical Method – *A posteriori* or Frequentist

Averages over the long run



$$P(\text{easy}) = 0.7$$

Assigning Probabilities

Empirical Method – *A posteriori* or Frequentist

Probability of having a monthly income of 1000 BHD is $10/23 = 0.43$

INCOME(BHD)	FREQUENCY
100	10
345	1
1000	10
9833	2

Assigning Probabilities

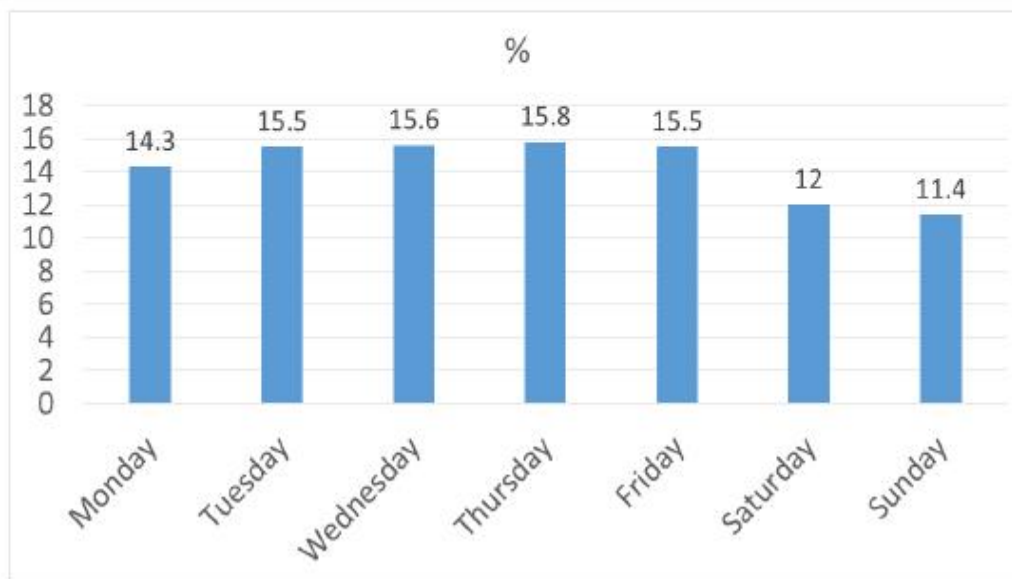
Subjective Method

Based on feelings, insights, knowledge, etc. of a person.

What is the probability of rain tomorrow?

Assigning Probabilities

What is the probability of a baby being born on a Sunday?



Strategic decisions must be based on hard data

"In God we trust; all others must bring data."

Edward Deming*



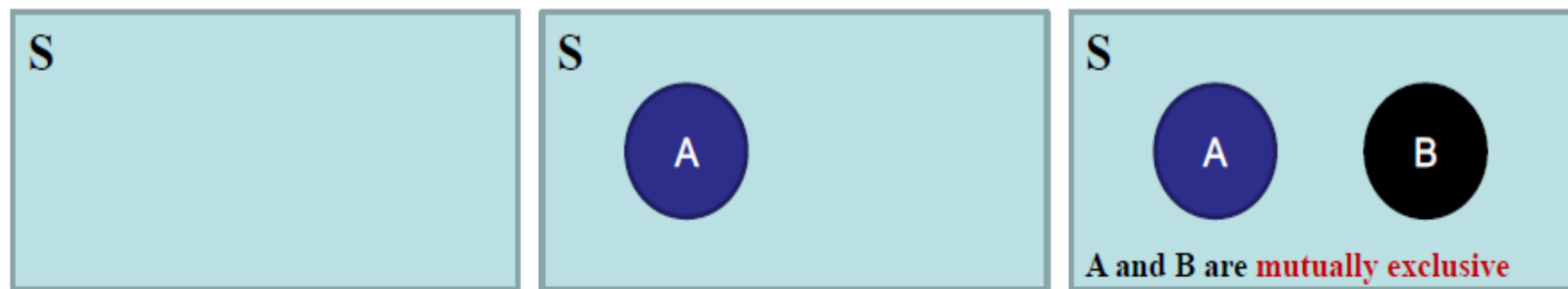
*The man behind Japanese post-war industrial revolution

Probability - Terminology

Sample Space – Set of all possible outcomes, denoted S .

Event – A subset of the sample space.

Probability - Rules



$$P(S) = 1$$

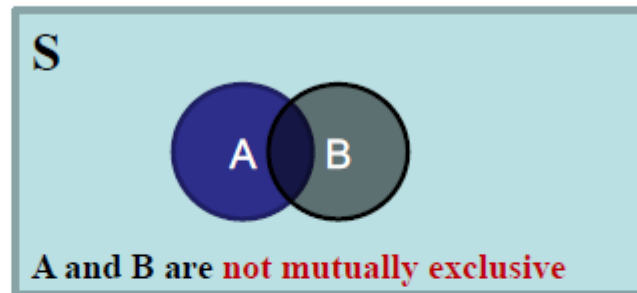
$$0 \leq P(A) \leq 1$$

$$P(A \text{ or } B) \\ = P(A) + P(B)$$

Area of the rectangle denotes sample space, and since probability is associated with area, it cannot be negative.

Mutually Exclusive – If event A happens, event B cannot.

Probability - Rules



$$P(A \text{ or } B) = P(A) + P(B) - P(A \text{ and } B)$$

Example

Event A – Customers who default on loans

Event B – Customers who are High Net Worth Individuals

Probability - Rules

Independent Events – Outcome of event B is not dependent on the outcome of event A.

Probability of customer B defaulting on the loan is not dependent on default (or otherwise) by customer A.

$$P(A \text{ and } B) = P(A) * P(B)$$

If the probability of getting an *easy* call is 0.7, what is the probability that the next 3 calls will be *easy*?

$$P(\text{easy}_1 \text{ and } \text{easy}_2 \text{ and } \text{easy}_3) = 0.7^3 = 0.343$$

Probability - Question

A basketball team is down by 2 points with only a few seconds remaining in the game. Given that:

- Chance of making a 2-point shot to tie the game = 50%
- Chance of winning in overtime = 50%
- Chance of making a 3-point shot to win the game = 30%

What should the coach do: go for 2-point or 3-point shot?

What are the assumptions, if any?



Probability - Types

Contingency table summarizing 2 variables, *Loan Default* and *Age*:

		Age			
		Young	Middle-aged	Old	Total
Loan Default	No	10,503	27,368	259	38,130
	Yes	3,586	4,851	120	8,557
	Total	14,089	32,219	379	46,687

Probability - Types

Convert it into probabilities:

		Age			
		Young	Middle-aged	Old	Total
Loan Default	No	0.225	0.586	0.005	0.816
	Yes	0.077	0.104	0.003	0.184
	Total	0.302	0.690	0.008	1.000

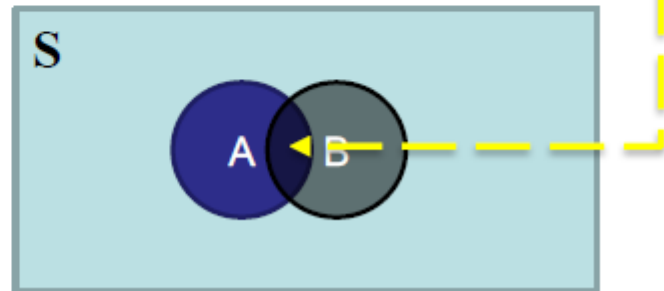
Probability - Types

Joint Probability

		Age			Total
		Young	Middle-aged	Old	
Loan Default	No	0.225	0.586	0.005	0.816
	Yes	0.077	0.104	0.003	0.184
Total		0.302	0.690	0.008	1.000

Probability describing a combination of attributes.

$$P(\text{Yes and Young}) = 0.077$$

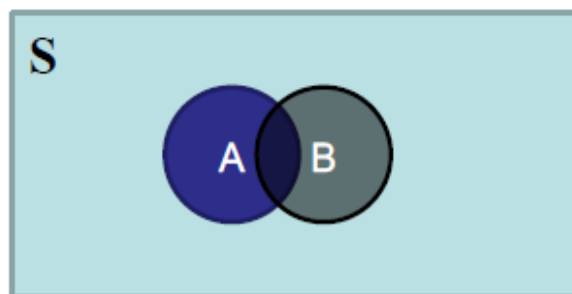


Probability - Types

Union Probability

		Age			Total
		Young	Middle-aged	Old	
Loan Default	No	0.225	0.586	0.005	0.816
	Yes	0.077	0.104	0.003	0.184
Total		0.302	0.690	0.008	1.000

$$P(\text{Yes or Young}) = P(\text{Yes}) + P(\text{Young}) - P(\text{Yes and Young}) \\ = 0.184 + 0.302 - 0.077 = 0.409$$



Probability - Types

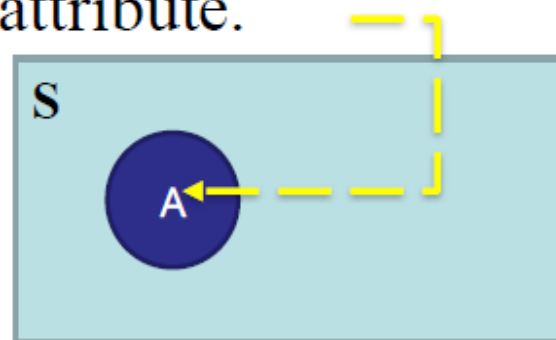
Marginal Probability

		Age			Total
		Young	Middle-aged	Old	
Loan Default	No	0.225	0.586	0.005	0.816
	Yes	0.077	0.104	0.003	0.184
Total		0.302	0.690	0.008	1.000

Probability describing a single attribute.

$$P(\text{No}) = 0.816$$

$$P(\text{Old}) = 0.008$$



Probability - Types

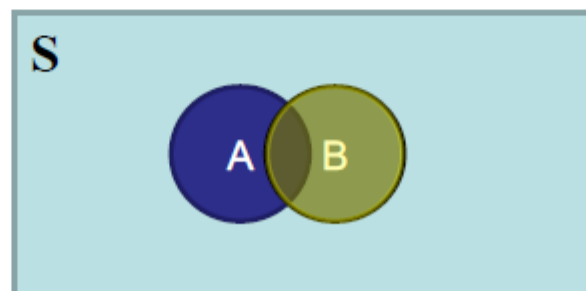
Conditional Probability

		Age			Total
		Young	Middle-aged	Old	
Loan Default	No	0.225	0.586	0.005	0.816
	Yes	0.077	0.104	0.003	0.184
Total		0.302	0.690	0.008	1.000

Probability of A occurring **given that** B has occurred.

The sample space is restricted to a single row or column.

This makes rest of the sample space irrelevant.



Probability - Types

Conditional Probability

		Age			Total
		Young	Middle-aged	Old	
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What is the probability that a person will not default on the loan payment **given** she is middle-aged?

$$P(\text{No} \mid \text{Middle-Aged}) = 0.586/0.690 = 0.85$$

Note that this is the ratio of

Probability - Types

Conditional Probability

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Note that this is the ratio of **Joint Probability** to **Marginal Probability**, i.e., $P(A|B) = \frac{P(A \text{ and } B)}{P(B)}$

Probability - Types

Conditional Probability

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$$P(\text{Middle-Aged} \mid \text{No}) =$$

Probability - Types

Conditional Probability

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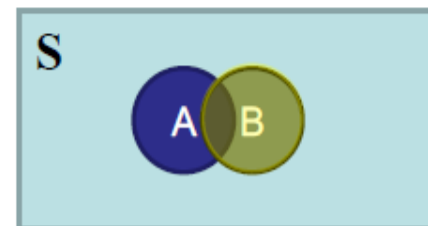
$$P(\text{Middle-Aged} \mid \text{No}) = 0.586/0.816 = 0.72 \text{ (Order Matters)}$$

Probability - Types

Conditional Probability – Visualizing using Probability Tables and Venn Diagrams

		Age			Total
		Young	Middle-aged	Old	
Loan Default	No	10,503	27,368	259	38,130
	Yes	3,586	4,851	120	8,557
Total		14,089	32,219	379	46,687

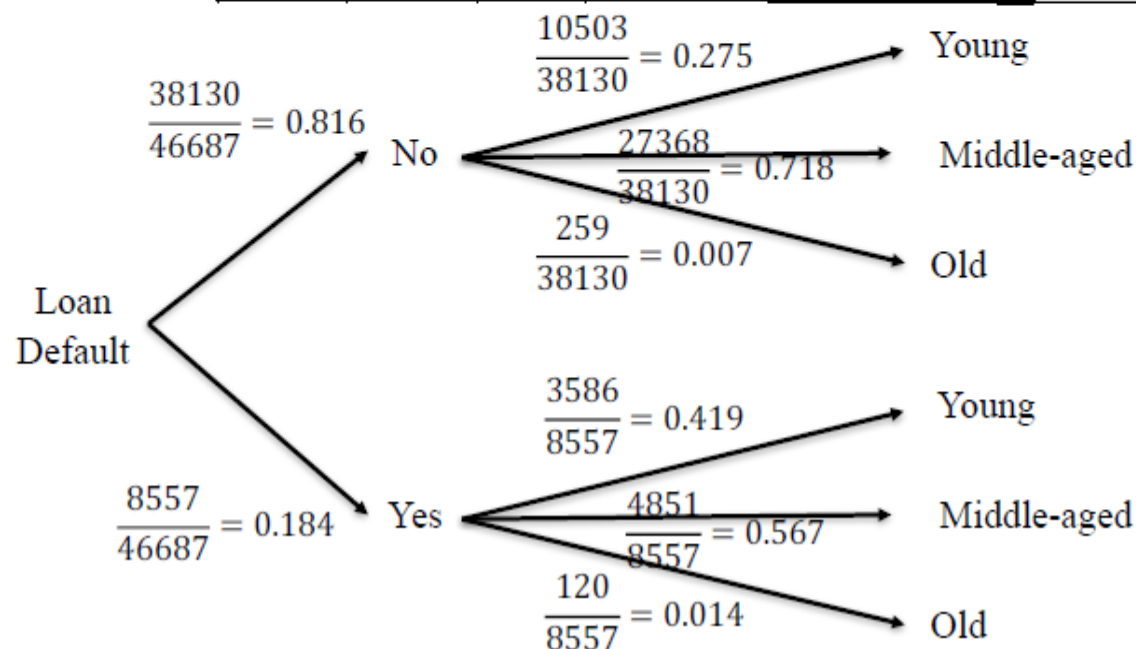
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Probability - Types

Conditional Probability – Visualizing using Probability Trees

		Age (Numbers)				Age (Probabilities)			
		Young	Middle-aged	Old	Total	Young	Middle-aged	Old	Total
Loan Default	No	10,503	27,368	259	38,130	0.225	0.586	0.005	0.816
	Yes	3,586	4,851	120	8,557	0.077	0.104	0.003	0.184
	Total	14,089	32,219	379	46,687	0.302	0.690	0.008	1.000



Find

- $P(\text{Old and Yes})$
- $P(\text{Yes and Old})$
- $P(\text{Old})$
- $P(\text{Yes})$
- $P(\text{Old} \mid \text{Yes})$
- $P(\text{Yes} \mid \text{Old})$
- $P(\text{Young} \mid \text{No})$



Probability - Types

Attention Check

Identify the type of probability in each of the below cases:

1. $P(\text{Old and Yes})$

2. $P(\text{Yes and Old})$

3. $P(\text{Old})$

4. $P(\text{Yes})$

5. $P(\text{Old} \mid \text{Yes})$

6. $P(\text{Yes} \mid \text{Old})$

7. $P(\text{Young} \mid \text{No})$

8. $P(\text{Middle-aged or No})$

9. $P(\text{Old or Young})$

		Age (Probabilities)			Total
		Young	Middle-aged	Old	
Loan Default	No	0.225	0.586	0.005	0.816
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Probability - Types

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1. $P(\text{Old and Yes})$

2. $P(\text{Yes and Old})$

3. $P(\text{Old})$

4. $P(\text{Yes})$

5. $P(\text{Old} \mid \text{Yes})$

6. $P(\text{Yes} \mid \text{Old})$

7. $P(\text{Young} \mid \text{No})$

8. $P(\text{Middle-aged or No})$

9. $P(\text{Old or Young})$

		Age (Probabilities)			Total
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Loan Default	No	0.225	0.586	0.005	0.816
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1 and 2: **Joint**; 3 and 4: **Marginal**; 5, 6 and 7: **Conditional**; 8 and 9: **Union**

Probability - Types

Conditional Probability

$$P(A|B) = \frac{P(A \text{ and } B)}{P(B)} \Rightarrow P(A \text{ and } B) = P(B) * P(A|B)$$

Similarly

$$P(B|A) = \frac{P(A \text{ and } B)}{P(A)} \Rightarrow P(A \text{ and } B) = P(A) * P(B|A)$$

Equating, we get

$$P(A|B) * P(B) = P(A) * P(B|A)$$

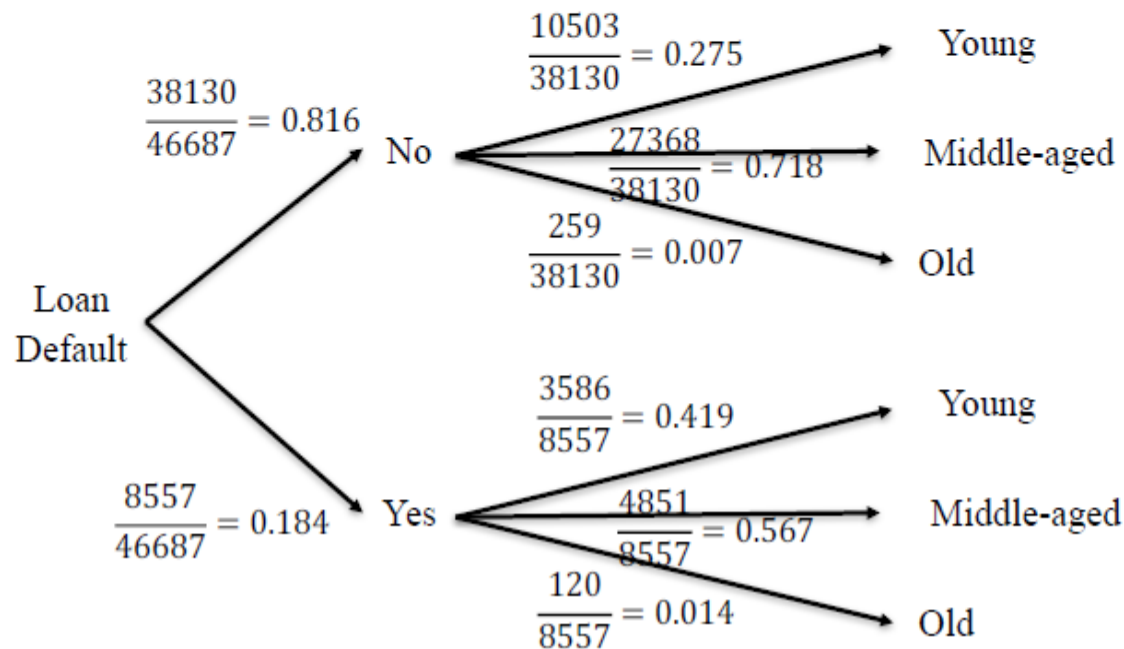
$$\therefore P(A|B) = \frac{P(A) * P(B|A)}{P(B)}$$

Probability - Types

Conditional Probability – Visualizing using Probability Trees

		Age (Probabilities)			Total
		Young	Middle-aged	Old	
Loan Default	No	0.225	0.586	0.005	0.816
	Yes	0.077	0.104	0.003	0.184
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$$P(A|B) = \frac{P(A) * P(B|A)}{P(B)}$$

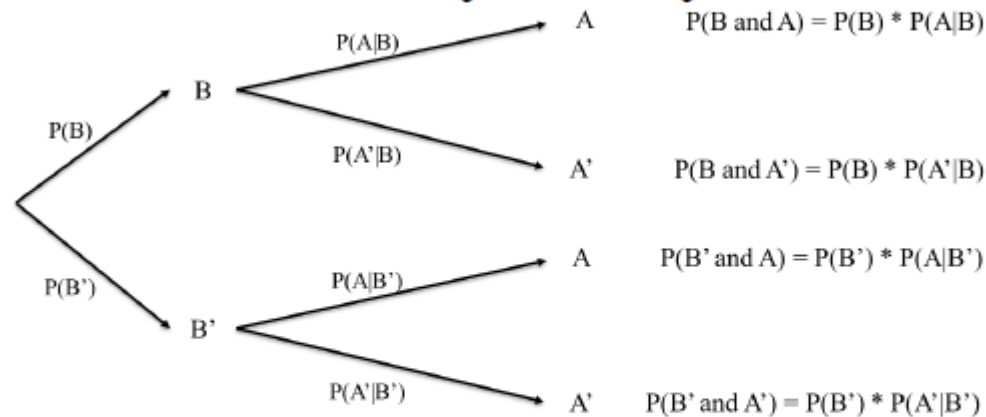


Now find
 $P(\text{Yes} | \text{Old})$



Probability - Types

Conditional Probability -> Bayes' Theorem



$$P(B|A) = \frac{P(B) * P(A|B)}{P(A)} = \frac{P(A|B) * P(B)}{P(A|B) * P(B) + P(A|not B) * P(not B)}$$

Note B' means "not B"

Bayes' Theorem

Bayes' Theorem allows you to find reverse probabilities, and to allow **revision of original probabilities** with new information.

Case – Clinical trials

Epidemiologists claim that probability of breast cancer among Caucasian women in their mid-50s is 0.005. An established test identified people who had breast cancer and those that were healthy. A new mammography test in clinical trials has a probability of 0.85 for detecting cancer correctly. In women without breast cancer, it has a chance of 0.925 for a negative result. If a 55-year-old Caucasian woman tests positive for breast cancer, what is the probability that she in fact has breast cancer?

Bayes' Theorem

Case – Clinical trials

$$P(\text{Cancer}) = 0.005$$

$$P(\text{Test positive} \mid \text{Cancer}) = 0.85 \text{ (aka Prior Probability)}$$

$$P(\text{Test negative} \mid \text{No cancer}) = 0.925$$

$$P(\text{Cancer} \mid \text{Test positive}) = ? \text{ (aka Posterior or Revised Probability)}$$

$$\begin{aligned} P(\text{Cancer} \mid \text{Test +}) &= \frac{P(\text{Cancer}) * P(\text{Test +} \mid \text{Cancer})}{P(\text{Test +} \mid \text{Cancer}) * P(\text{Cancer}) + P(\text{Test +} \mid \text{No cancer}) * P(\text{No cancer})} \\ &= \frac{0.005 * 0.85}{0.85 * 0.005 + 0.075 * 0.995} = \frac{0.00425}{0.078875} = 0.054 \end{aligned}$$

Homework

Draw a Probability Table and a Probability Tree for the above case.

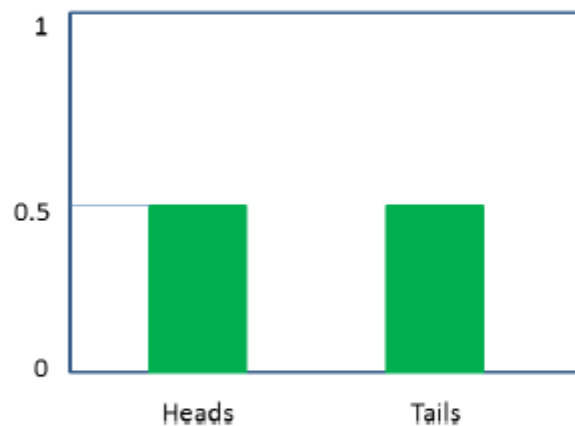
Analyzing attributes

PROBABILITY DISTRIBUTIONS

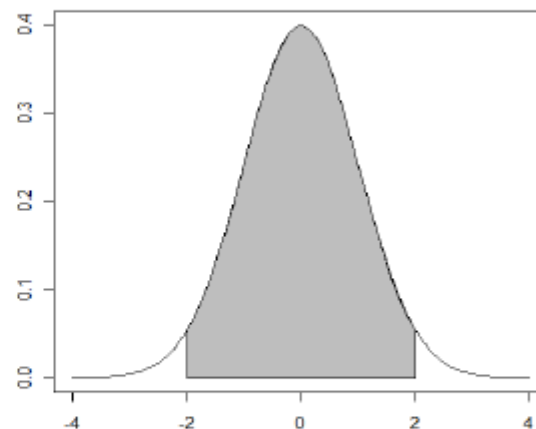
Random variable

- A variable that can take multiple values with different probabilities.
- The mathematical function describing these possible values along with their associated probabilities is called a probability distribution.

Discrete and Continuous



Countable



Measurable

Can any function be a probability distribution?

Discrete Distributions	Continuous Distributions
Probability that X can take a specific value x is $P(X = x) = p(x)$.	Probability that X is between two points a and b is $P(a \leq X \leq b) = \int_a^b f(x)dx$.
It is non-negative for all real x .	It is non-negative for all real x .
The sum of $p(x)$ over all possible values of x is 1, i.e., $\sum p(x) = 1$.	$\int_{-\infty}^{\infty} f(x)dx = 1$
Probability Mass Function	Probability Density Function

Histogram

A series of contiguous rectangles that represent the frequency of data in given class intervals.

How many class intervals?

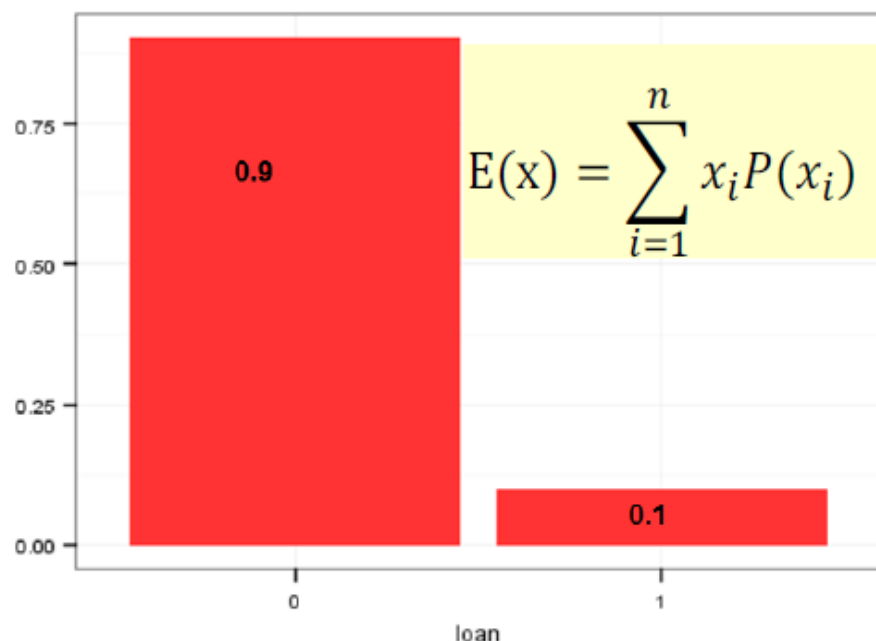
Rule of thumb: 5-15 (not too many and not too few)

Freedman-Diaconis rule:

$$\text{No. of bins} = \frac{(\max - \min)}{2 * IQR * n^{\frac{1}{3}}},$$

where the denominator is the bin – width

Expectation: Discrete



Recall anything like this?

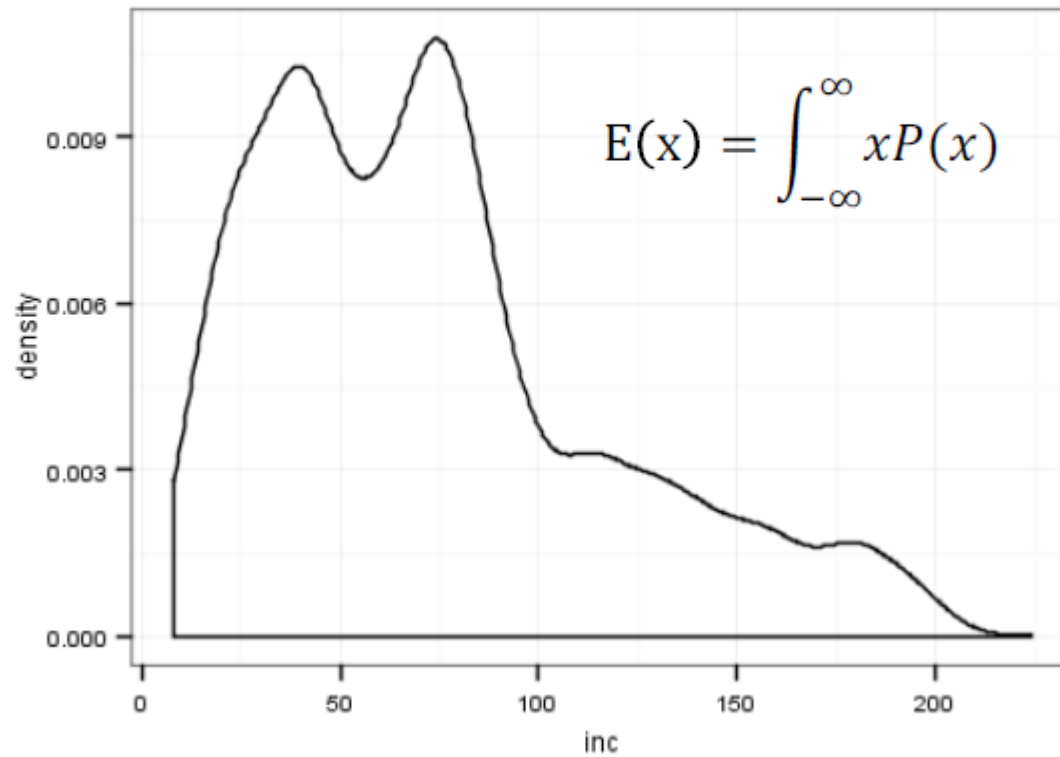
Salary (BHD)	100	345	1000	9833
Frequency, f	10	1	10	2
Probability	0.43	0.04	0.43	0.09

$$\text{Mean, } \mu = \frac{\sum x}{n} = \frac{\sum fx}{\sum f} = \frac{100 \times 10 + 345 \times 1 + 1000 \times 10 + 9833 \times 2}{10 + 1 + 10 + 2} = 1348$$

$$\text{Expectation, } E(X) = 100 * 0.43 + 345 * 0.04 + 1000 * 0.43 + 9833 * 0.09 = 1348$$



Expectation: Continuous



Describing a Distribution – Summary of Moments

Measure	Formula	Description
Mean (μ)	$E(X)$	Measures the centre of the distribution of X
Variance (σ^2)	$E[(X - \mu)^2]$	Measures the spread of the distribution of X about the mean

Simplifying the Formula

$$E[(X - \mu)^2] = E[X^2 - 2\mu X + \mu^2]$$

$$= E[X^2] - 2\mu E[X] + \mu^2 \text{ (we get this from previous formula as } \mu \text{ is just a number)}$$

$$= E[X^2] - 2\mu^2 + \mu^2$$

$$= E[X^2] - \mu^2 = E[X^2] - [E(X)]^2$$

Expectation Properties

$E(X+Y) = E(X) + E(Y)$ e.g., Playing a game each on 2 slot machines with different probabilities of winning. This is called Independent Observation.

$E(aX+b) = aE(X)+E(b) = aE(X) + b$ e.g., values x have been changed. This is called Linear Transformation.

If I have a portfolio of 30% TCS, 50% Wipro and 20% Ranbaxy stocks, the expected return of my portfolio is

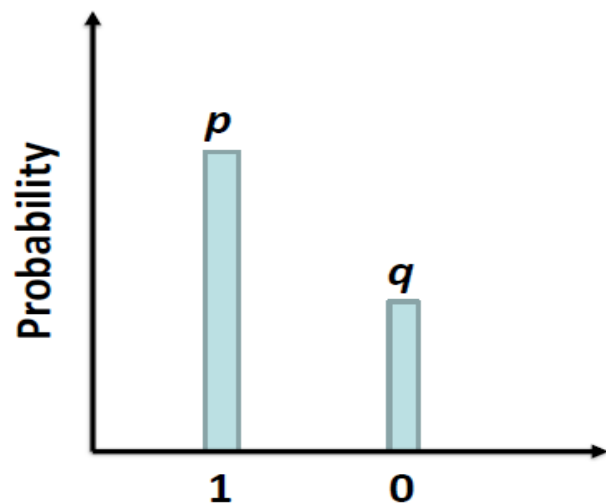
$$E(\text{Portfolio}) = 0.3 E(\text{TCS}) + 0.5 E(\text{Wipro}) + 0.2 E(\text{Ranbaxy})$$

SOME COMMON DISTRIBUTIONS

Bernoulli

There are two possibilities (loan taker or non-taker) with probability p of success and $1-p$ of failure

- Expectation: p
- Variance: $p(1-p)$ or pq , where $q=1-p$



Geometric Distribution

Number of independent and identical Bernoulli trials needed to get ONE success, e.g., number of people I need to call for the first person to accept the loan.

Geometric Distribution

PMF*, $P(X = r) = q^{r-1}p$ $(r-1)$ failures followed by ONE success.

$P(X > r) = q^r$ Probability you will need more than r trials to get the first success.

CDF**, $P(X \leq r) = 1 - q^r$ Probability you will need r trials or less to get your first success.

$$E(X) = \frac{1}{p} \quad \text{Var}(X) = \frac{q}{p^2}$$

* Probability Mass Function ** Cumulative Distribution Function

Geometric Distribution

- You run a series of independent trials.
- There can be either a success or a failure for each trial, and the probability of success is the same for each trial.
- The main thing you are interested in is how many trials are needed in order to get the first successful outcome.

Binomial Distribution

If there are two possibilities with probability p for success and q for failure, and if we perform n trials, the probability that we see r successes is

$$\text{PMF, } P(X = r) = C_r^n p^r q^{n-r}$$

$$\text{CDF, } P(X \leq r) = \sum_{i=0}^r C_i^n p^i q^{n-i}$$

Binomial Distribution

$$E(X) = np$$

$$Var(X) = npq$$

When to use?

- You run a series of independent trials.
- There can be either a success or a failure for each trial, and the probability of success is the same for each trial.
- There are a finite number of trials, and you are interested in the number of successes or failures.

Poisson Distribution

Probability of getting 15 customers requesting for loans in a given day given on average we see 10 customers

$$\lambda = 10 \text{ and } r = 15$$

$$\text{PMF, } P(X = r) = \frac{e^{-\lambda} \lambda^r}{r!}$$

$$\text{CDF, } P(X \leq r) = e^{-\lambda} \sum_{i=0}^r \frac{\lambda^i}{i!}$$

Poisson Distribution

$E(X) = \lambda$ Can be equated to np of Binomial if n is large (>50) and p is small (<0.1)

$Var(X) = \lambda$ Can be equated to npq of Binomial in the above situation.

When to use?

- Individual events occur at random and independently in a given interval (time or space).
- You know the mean number of occurrences, λ , in the interval or the rate of occurrences, and it is finite.

Poisson Distribution

The probability that no customer will visit the store in one day

$$P(X=0) = \frac{e^{-\lambda} \lambda^0}{0!} = e^{-\lambda}$$

Probability that she will not have a customer for n days

$$e^{-n\lambda}$$

Exponential Distribution

Probability that a customer will visit in n days: $1 - e^{-n\lambda}$

$$CDF = 1 - e^{-n\lambda}, n \geq 0$$

$$PDF = \lambda e^{-n\lambda}, n \geq 0$$

Distributions

- Geometric: For estimating number of attempts before first success
- Binomial: For estimating number of successes in n attempts
- Poisson: For estimating n number of events in a given time period when on average we see m events
- Exponential: Time between events

Probability Distributions

Here are a few scenarios. Identify the distribution and calculate expectation, variance and the required probabilities.

- Q1. A man is bowling. The probability of him knocking all the pins over is 0.3. If he has 10 shots, what is the probability he will knock all the pins over less than 3 times?
- Q2. On average, 1 bus stops at a certain point every 15 minutes. What is the probability that no buses will turn up in a single 15 minute interval?
- Q3. 20% of cereal packets contain a free toy. What is the probability you will need to open fewer than 4 cereal packets before finding your first toy?



Probability Distributions

Solutions

A man is bowling. The probability of him knocking all the pins over is 0.3. If he has 10 shots, what is the probability he will knock all the pins over less than 3 times?

$$X \sim B(10, 0.3); n=10, p=0.3, q=1-0.3=0.7, r=0, 1, 2 (< 3)$$

$$E(X) = np = 3$$

$$\text{Var}(X) = npq = 2.1$$

$$P(X = r) = {}^nC_r p^r q^{n-r}$$

$$P(X=0) = 0.028; P(X=1) = 0.121; P(X=2) = 0.233$$

$$\therefore P(X < 3) = 0.028 + 0.121 + 0.233 = 0.382$$

Probability Distributions

Solutions

On average, 1 bus stops at a certain point every 15 minutes. What is the probability that no buses will turn up in a single 15 minute interval?

$$X \sim \text{Po}(1); \lambda=1, r=0$$

$$E(X) = \lambda = 1$$

$$\text{Var}(X) = \lambda = 1$$

$$P(X = r) = \frac{e^{-\lambda} \lambda^r}{r!}$$

$$P(X=0) = 0.368$$