

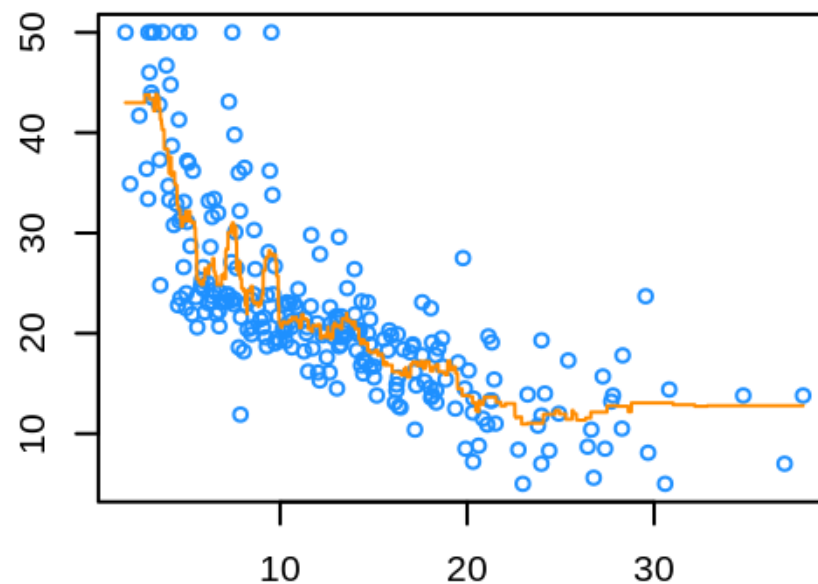
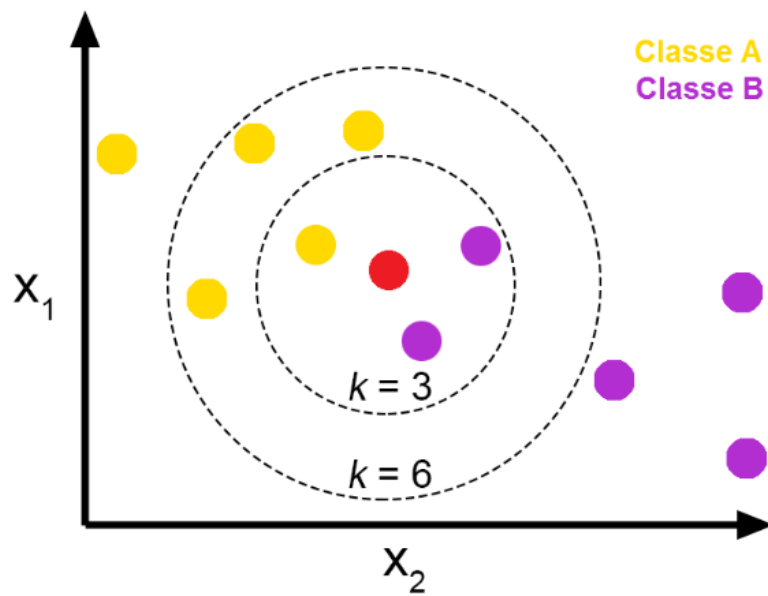


Module 8 – KNN

K-Nearest Neighbors



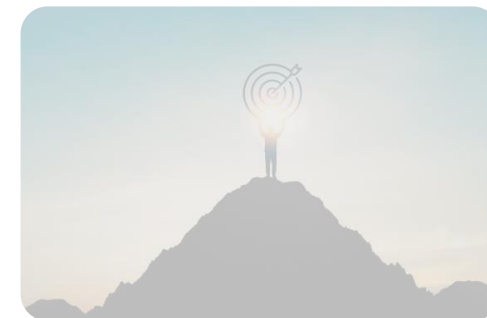
Prof. Pedram Jahangiry





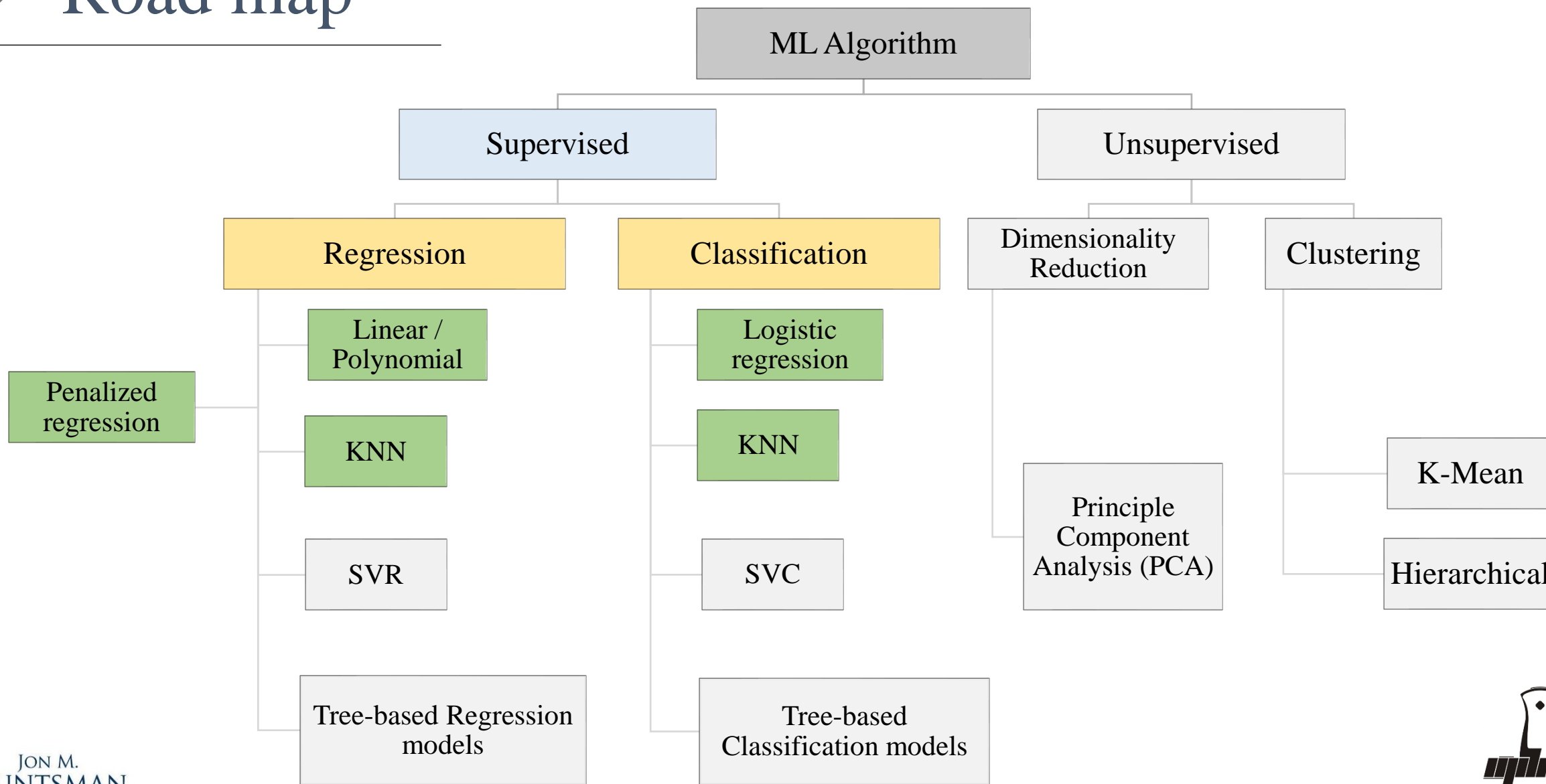
Class Modules

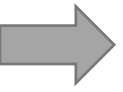
- Module 1- Introduction to Machine Learning
- Module 2- Setting up Machine Learning Environment
- Module 3- Linear Regression (Econometrics approach)
- Module 4- Machine Learning Fundamentals
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- Module 6- Penalized Regression (Ridge, LASSO, Elastic Net)
- Module 7- Logistic Regression
- **Module 8- K-Nearest Neighbors (KNN)**
- Module 9- Classification and Regression Trees (CART)
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- Module 12- Clustering (KMeans – Hierarchical)





Road map





Topics

Part I

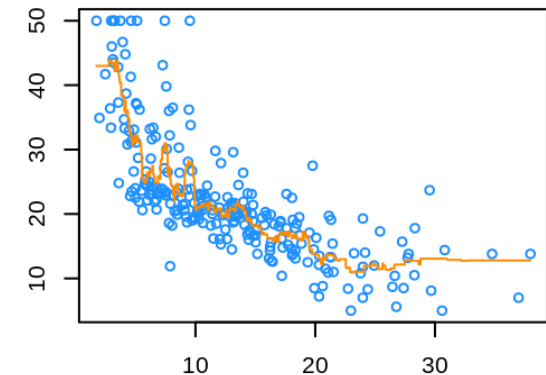
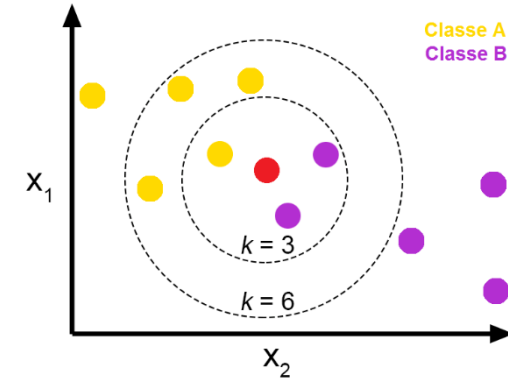
1. KNN Classification
2. Performance metrics and choice of K

Part II

1. KNN Regression
2. KNN vs Linear Regression
3. Performance metrics and choice of K

Part III

1. Curse of Dimensionality
2. Pros and Cons of KNN
3. KNN applications in Finance

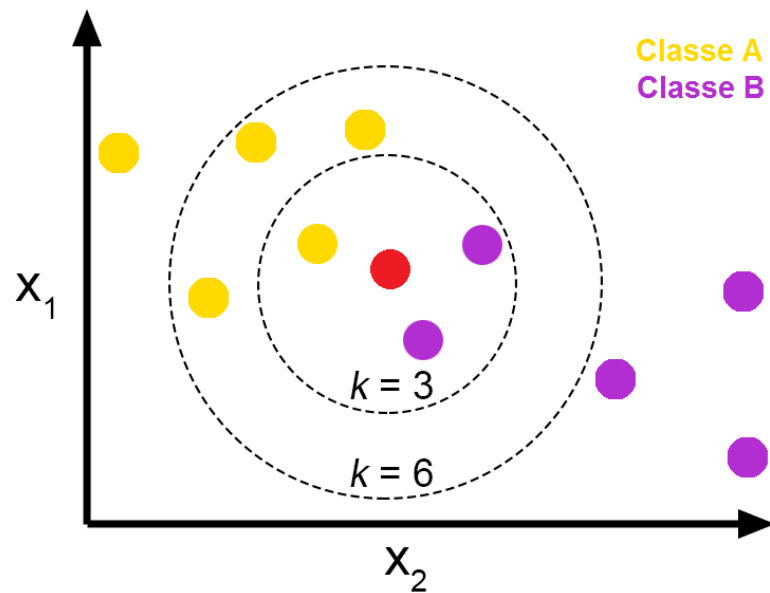


Part I

KNN Classification

→ KNN (K-Nearest Neighbors)

K-nearest neighbor (KNN) is one of the simplest and best-known **non-parametric supervised** learning technique most often used for **classification**. The idea is to classify a new observation by finding **similarities** (“nearness”) between it and its k -nearest neighbors in the existing dataset.



- The choice of the **distance metric**, as well as the **value for k** , are the choices the analyst makes before running the algorithm. So, these are **hyperparameters**.
- Contrary to other learning algorithms that allow discarding the training data after the model is built, KNN **keeps all training examples in memory**.

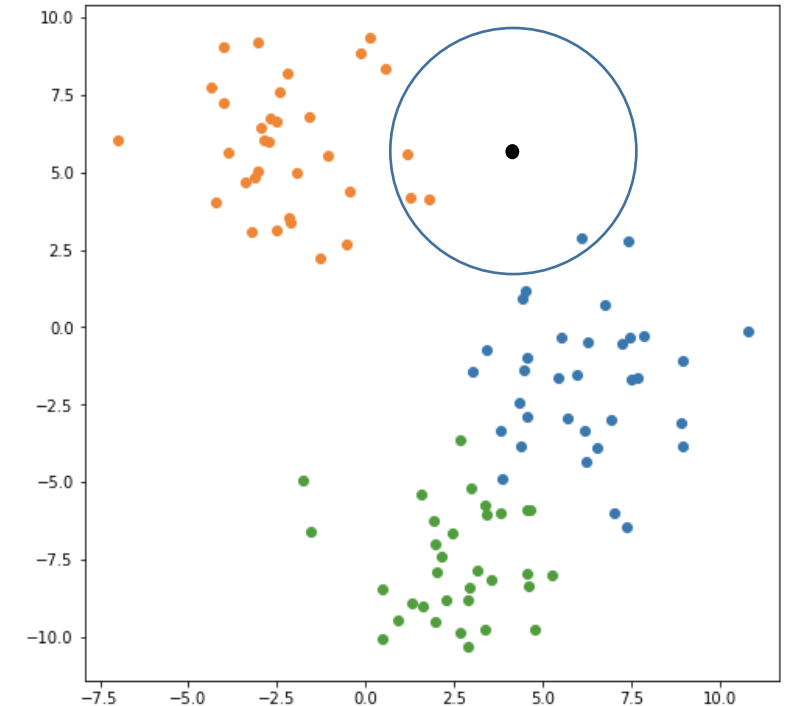


KNN steps

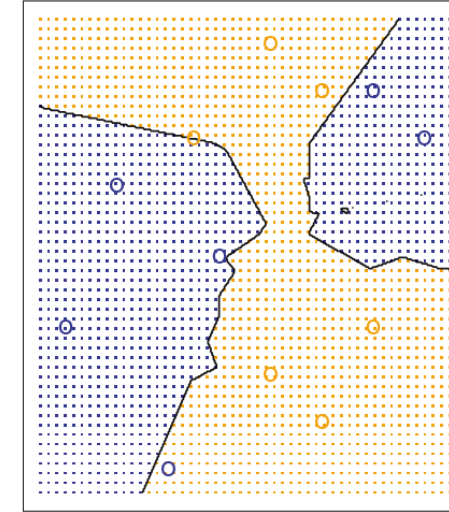
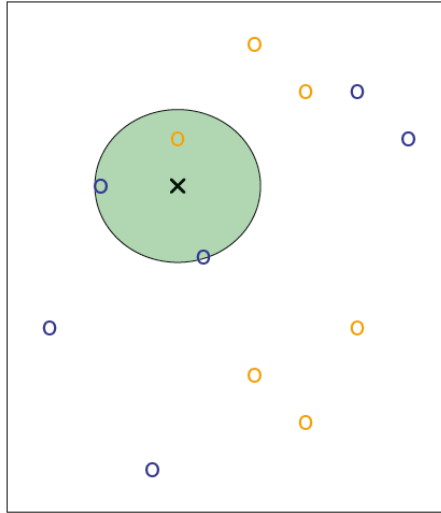
1. Choose number of neighbors **K** (positive integer)
2. Choose the distance metric (Minkowski, Euclidian, Manhattan, etc.)
3. Identify the K points in the training data that are closest to x_{te} in the test set. This **neighborhood** is represented by N_0 .
4. Estimate the **conditional probability** for class j as the fraction of points in N_0 whose response values equal j:

$$\Pr(Y = j \mid X = x_{te}) = \frac{1}{K} \sum_{i \in N_0} I(y_i = j)$$

5. Classifies the test observation x_{te} to the class with the largest probability.

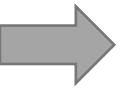


→ KNN Decision Boundary



- Two classes: blue and orange!
- Black cross: a test observation.
- When $K=3$, black cross is classified as:
Blue
- Repeat this process for every potential element in the feature space!

- KNN **decision boundary** is shown in **black**.
- The blue grid indicates the region in which a test observation will be assigned to the blue class, and
- the orange grid indicates the region in which it will be assigned to the orange class.



Performance metrics

- Error rate = $1 - \text{Accuracy}$

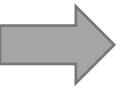


$$\text{Accuracy} = \frac{TN + TP}{TN + TP + FN + FP}$$

$$\frac{1}{n} \sum_{i=1}^n I(y_i \neq \hat{y}_i)$$

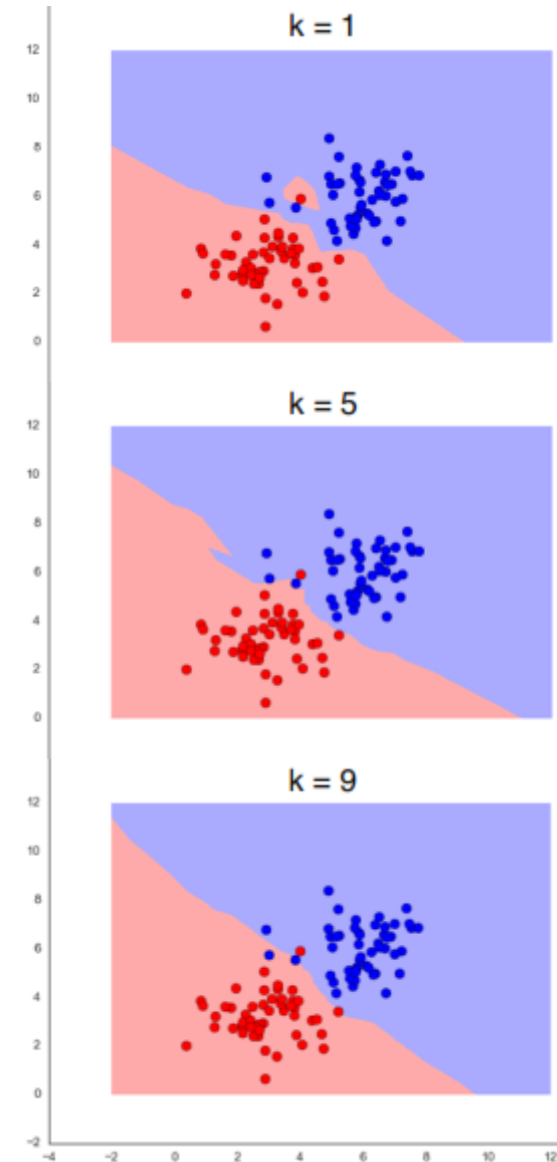
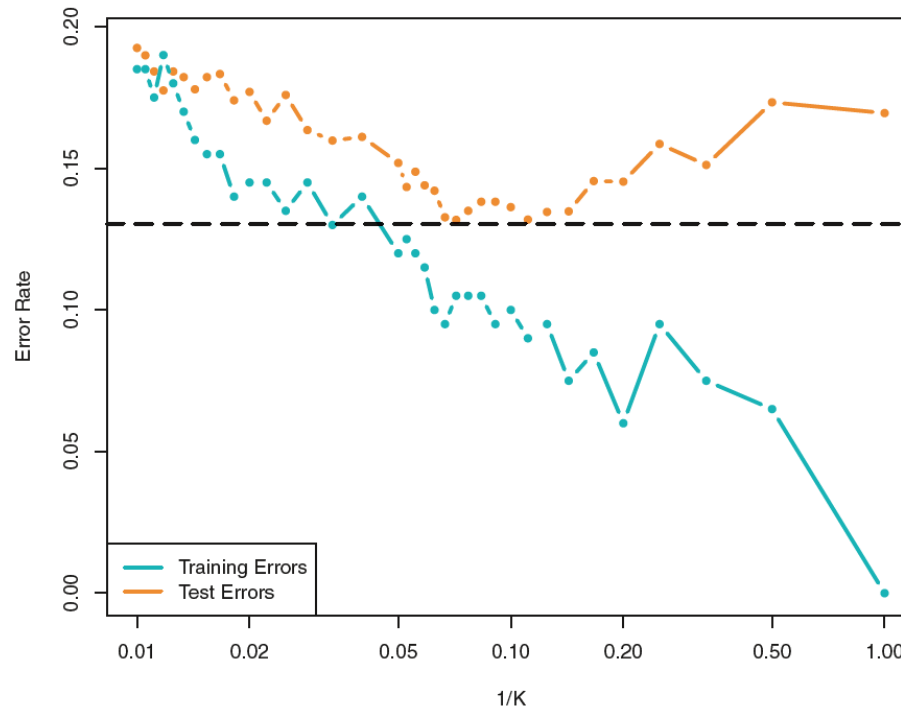
		Predictions	
		0 negative	1 positive
Actual	0 negative	TN	FP
	1 positive	FN	TP

- A good classifier is one for which the **test error** is smallest.
- Like any other classifier, if the data is highly imbalanced, then we should use f1score, precision and recall instead of the error rate.



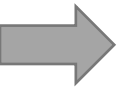
Choice of K (Bias Variance Trade Off)

- $K=1$ very flexible model: Low bias but high variance.
- As K grows, less flexible model, decision boundary gets close to linear. This corresponds to a low variance but high bias.
- Optimal value of K :



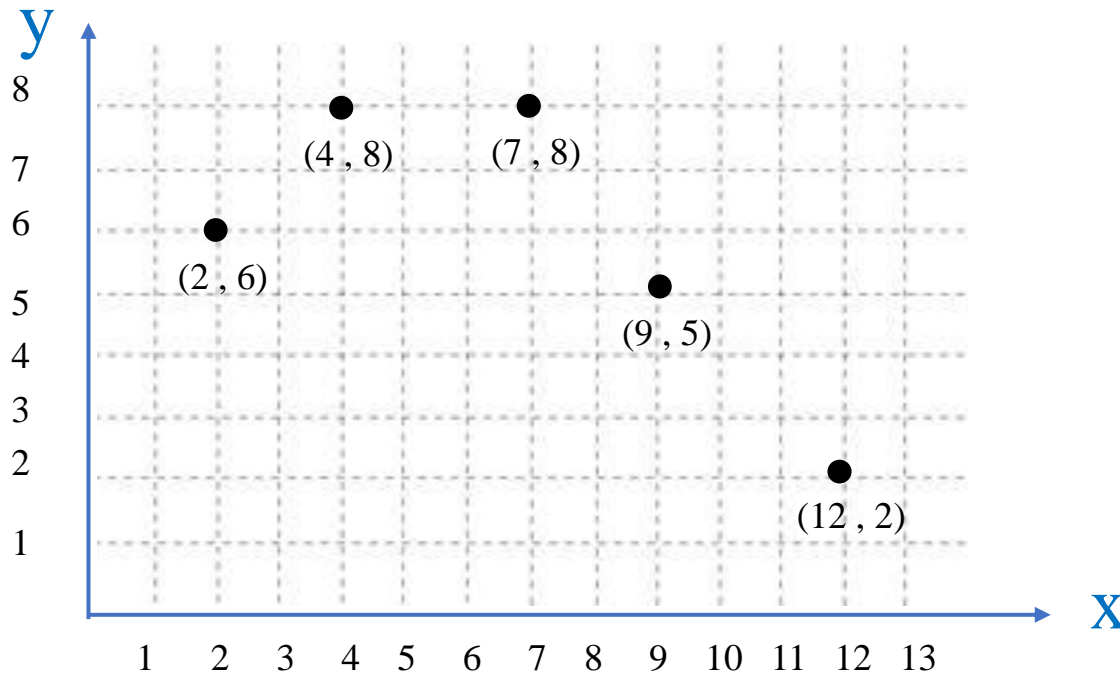
Part II

KNN Regression



KNN Regression

- The KNN regression method is closely related to the KNN classifier

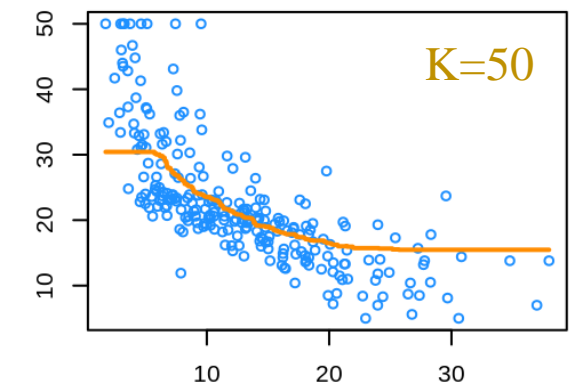
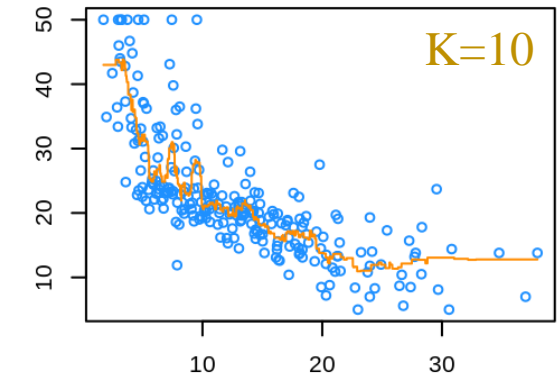
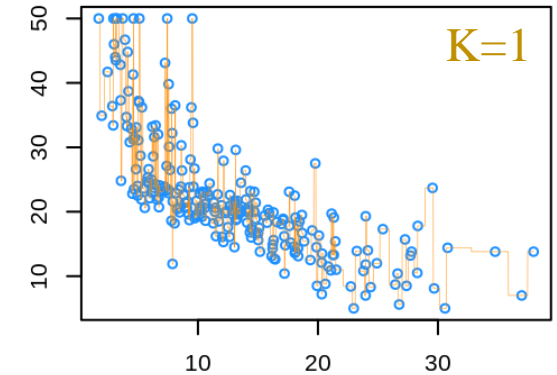
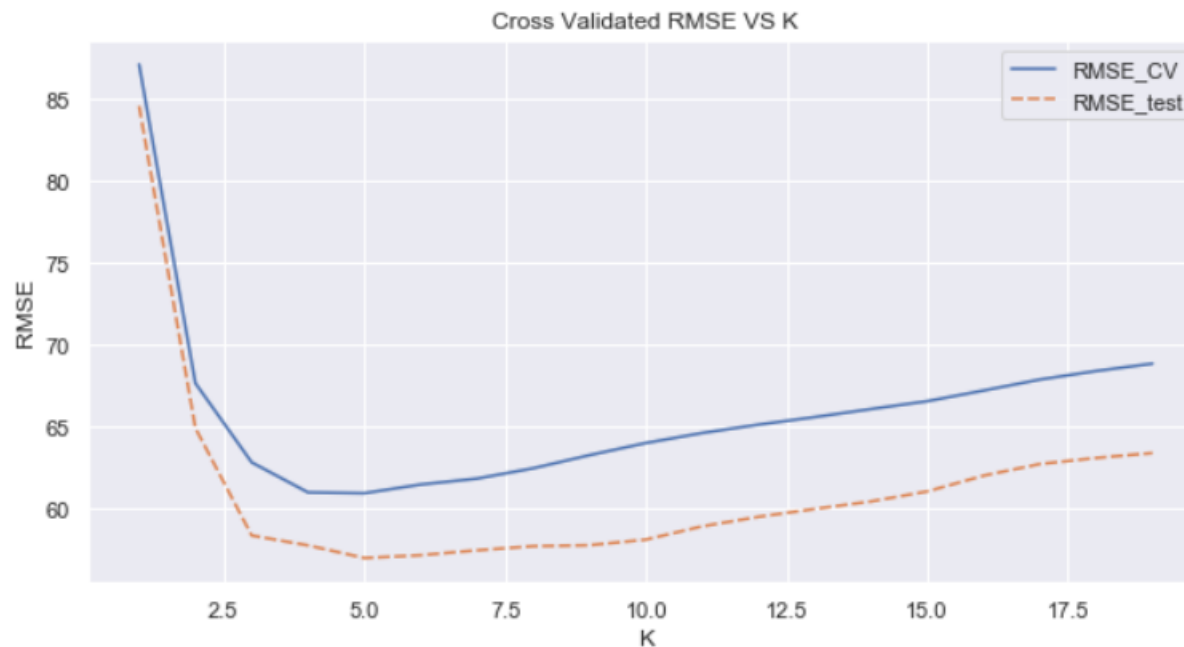


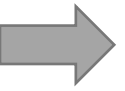
$$\hat{f}(x_{te}) = \frac{1}{K} \sum_{i \in N_0} y_i$$



Choice of K (Bias Variance Trade Off)

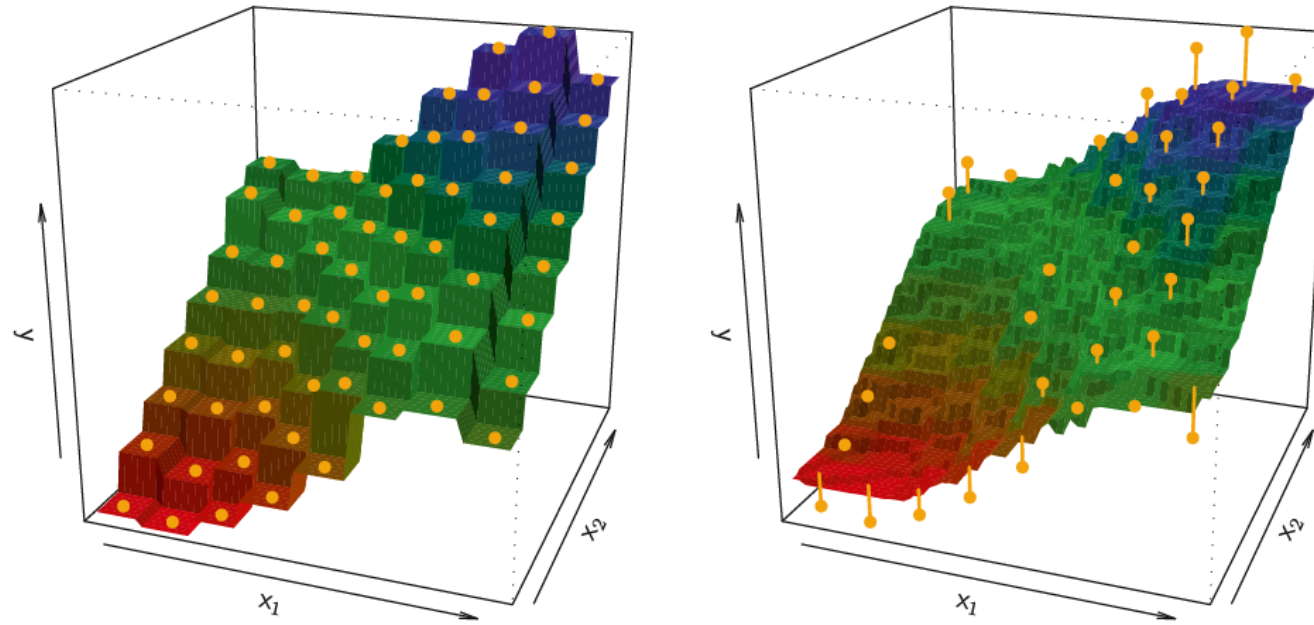
- $K=1$ very flexible model: Low bias but high variance.
- As K grows, less flexible model, regression fit gets smoother and smoother. This corresponds to a low variance but high bias.
- Optimal value of K :

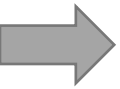




Choice of K (Bias Variance Trade Off)

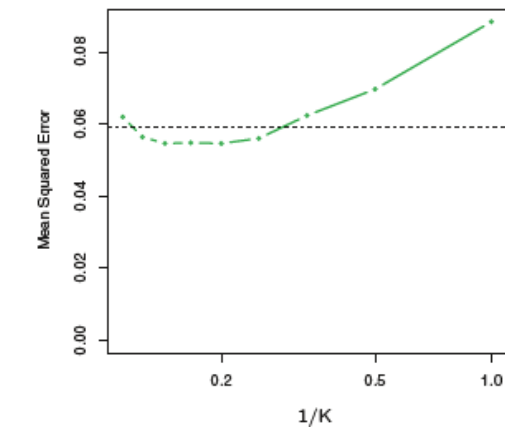
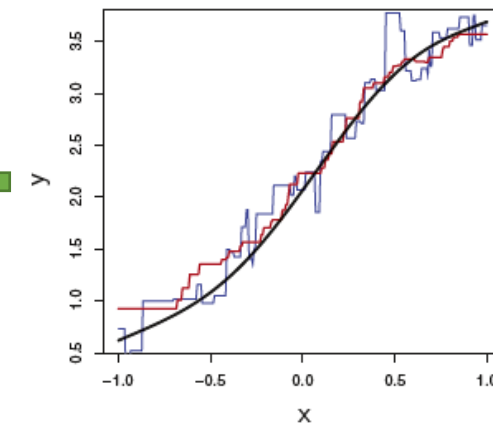
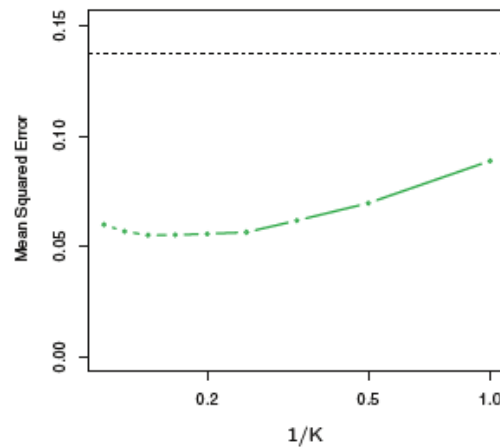
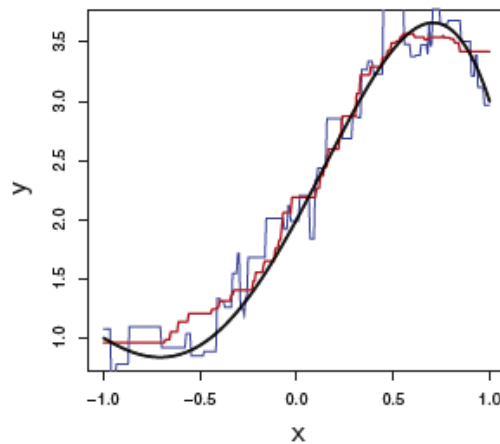
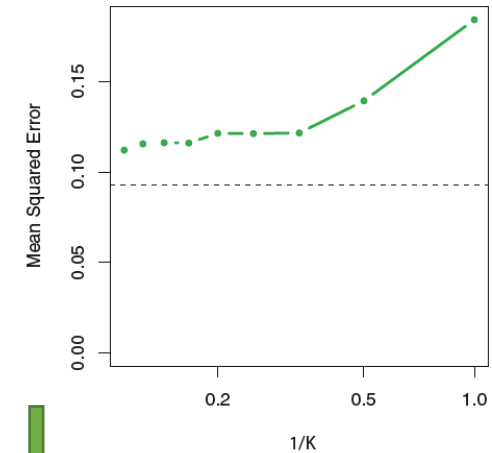
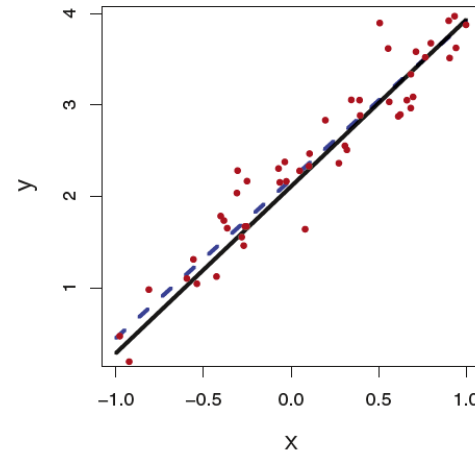
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Linear regression vs KNN regression

- Black curve is the true relationship between y and X
- Green dashed line: KNN MSE_{test}
- Black dashed line: OLS MSE_{test}
- The more non-linear the true relationship, the better performance of KNN compared to OLS.



Part III

Pros and Cons

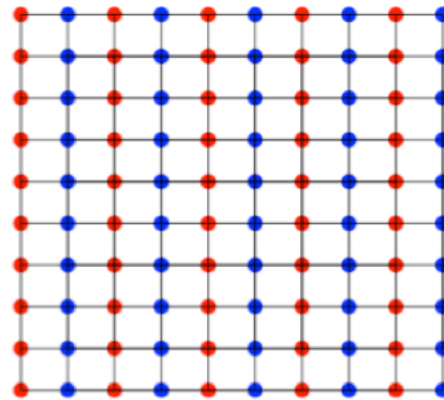
Applications in Finance

→ Curse of Dimensionality

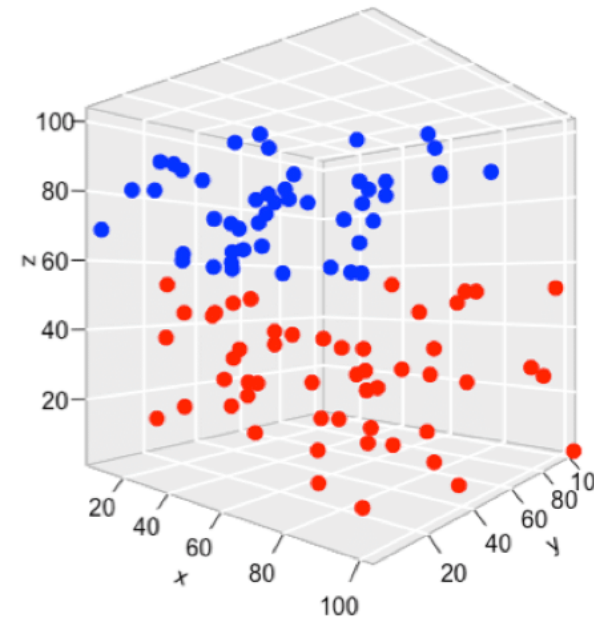
- The “Curse of Dimensionality” is a problem with the relationship between **dimensionality** and **volume**.
- Sparsity of data occurs when moving to higher dimensions. the volume of the space represented grows so quickly that the data **cannot keep up** and thus becomes sparse. (*Bellman, 1957*)



(A) 1-D



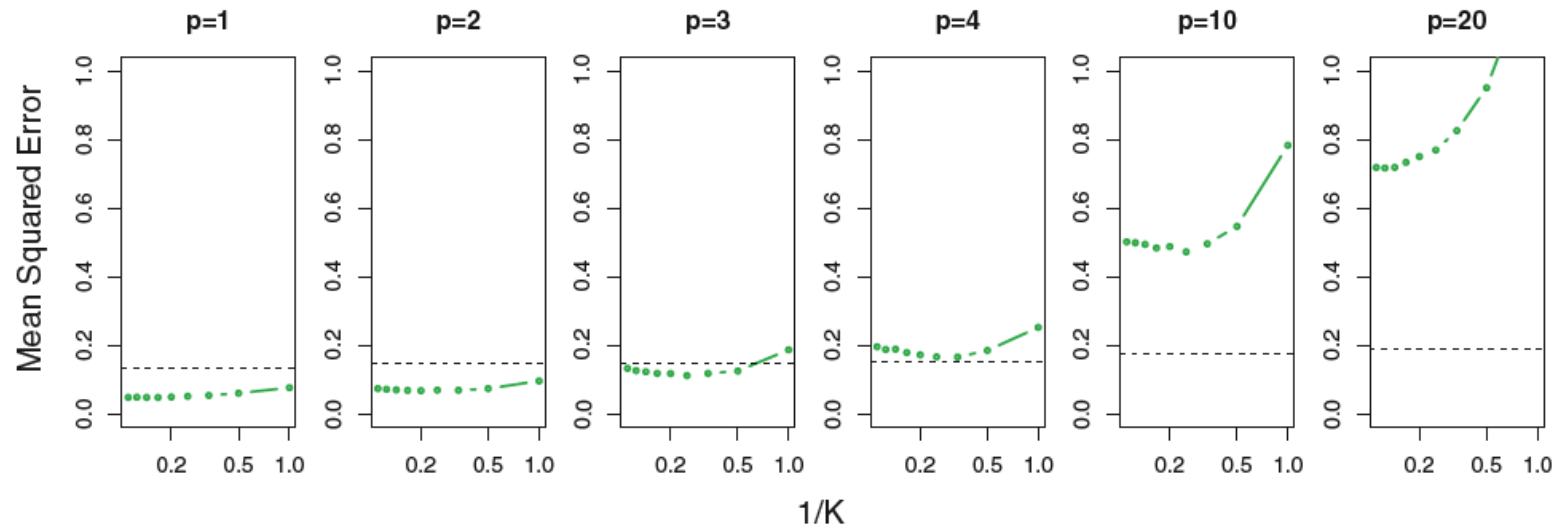
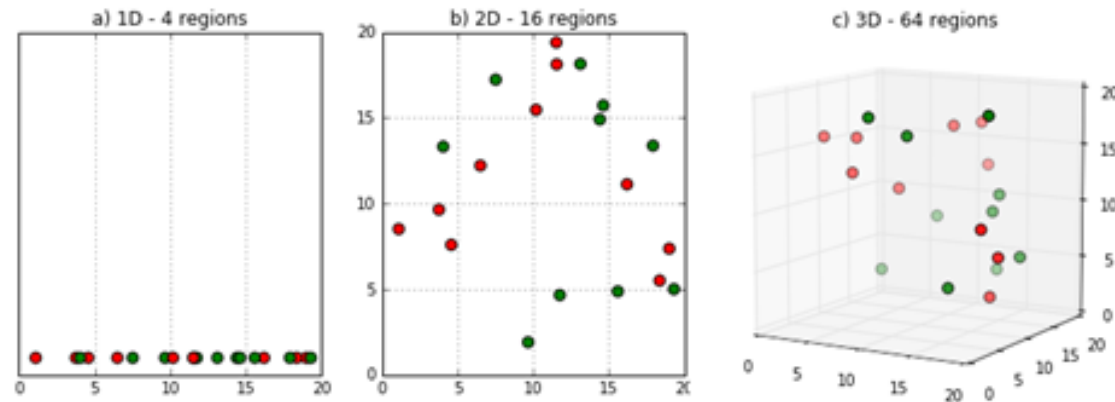
(B) 2-D

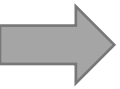


(C) 3-D



KNN and the Curse of Dimensionality





KNN's Pros and Cons

Pros:

- Intuitive and simple
- No assumption (non-parametric)
- Easy to implement for multi-class problem
- Used both for classification and regression
- Few parameters/hyper-parameters

Cons:

- Slow (memory-based approach)
- Curse of dimensionality
- Not good with multiple categorical features
- Choice of K
- No interpretation (None!)



→ KNN Applications in finance

- Bankruptcy prediction
- Stock price prediction (buy/sell/hold)
- Corporate bond credit rating assignments
- Money laundering analysis
- Bank customer profiling
- Loan management
- Customized equity and bond index creation





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