

CHAPTER 1

INTRODUCTION

1.1 TOPICS

Some of the topics covered in this module include:

- Exposure to the language of modeling.
- Exploration of different types of models used in business and how to apply them in practice.
- Process of modeling.
- Characteristics of the models.
- Value and limitations of quantitative models. What sort of things they can and cannot do. Understand the limitations of the models.
- Provide a set of foundational for other courses in specialization.

Which model should I use?

Process: map the characteristics of the business into the characteristics of the model.

1.2 DEFINITION, USES OF A MODEL, COMMON FUNCTIONS

In the business context, the models we are talking about are not physical models (different from the idea an architect has). We are talking about a **formal description of a business process**.

This description is going to involve a set of mathematical equations and/or random variables.

Observation 1.2.1

A quantitative model it is almost always a simplification of a more complex structure (in particular, of a business process). We do not want to over simplify, but we also do not want to overcomplicate.

Turns out it's going to be really difficult to make an exact and accurate representation of what we really want to model.

Also, there is a set of **assumptions** that underly the model. We have to check whether these assumptions are reasonable or not in our business process.

Observation 1.2.2

A model is usually implemented in Excel or a spreadsheet tool like Google Sheets (or using programming languages as *R*).

In a more mathematical way, we can define a model as follows:

Definition 1.2.1 (Model)

A model is a triplet $M = (X, \Theta, F)$, where:

- X is a set of measurable input variables (data).

- Θ is a set of parameters and,
- $F : X \times \Theta \rightarrow Y$ is a function, that maps input and parameters to measurable output in Y .

Let's give some examples:

Example 1.2.1

Some examples of models are the following:

- Determine the price of a diamond given its weight.
- The spread of an epidemic over time.
- Relationship between demand for, and price of a product.
- The uptake of a new product in market.

In particular, if I have a product and I want to maximize the gains we acquire when selling it, how can we achieve this goal?

All of these examples are from different areas, but can be addressed by using a quantitative model.

1.2.1 DIAMONDS AND WEIGHT

Let's consider the weight of a diamond and the price it is going to have. We have the following equation that models the price of a diamond given its weight:

$$p(w) = -260 + 3721w$$

This is a linear model. The price is given in dollars and the weight is given in carats. Sometimes we use a visual representation like this:

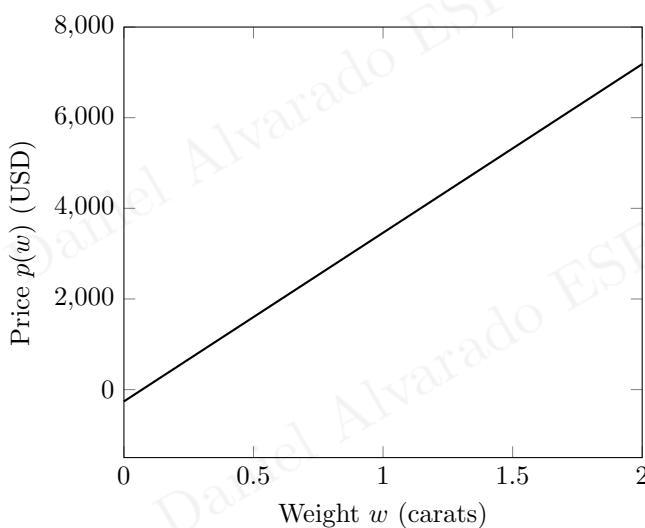


Figure 1.1: Model of the Price of a Diamond

Basically, this model allows us to forecast the price of a certain object given certain properties of it or *data about it*. This is a **linear model**.

Observation 1.2.3

A model doesn't necessarily have to work in all the circumstances. For example, the model given to obtain the price of a diamond doesn't necessarily have to be applicable to a different company.

1.2.2 SPREADING OF AN EPIDEMIC

Depending on the disease and other factors (such as time in which the epidemic occurred), one model arises.

One of the basic models to start with is the **exponential model**. On the bottom axis we have weeks (since the start of the epidemic), and on the vertical axis we have the number of cases reported.

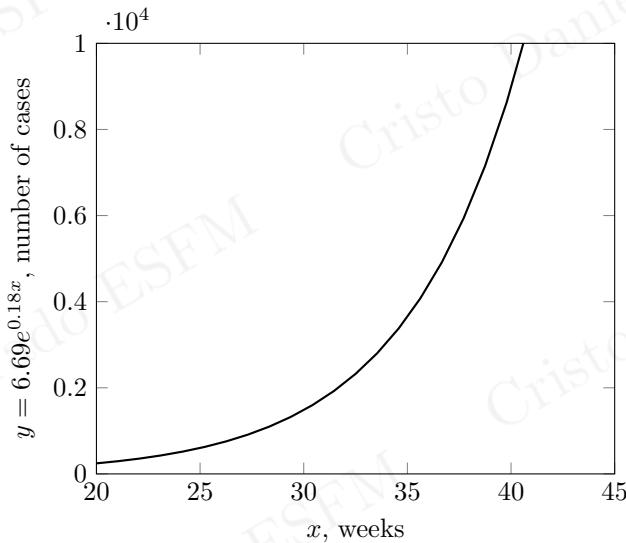


Figure 1.2: Exponential Model for the spread of an epidemic.

The equation to describe this model is:

$$y = 6.69e^{0.18x}$$

Observation 1.2.4

This model is suitable for the start of the pandemic, since there is not an unlimited number of people, we cannot expect that the growth of the graph is unstoppable.

Observation 1.2.5 (Exponential Graphs)

In the context of business they are called **hockey sticks**.

This model is not suitable for a long term, but its suitable for an approximation over the first weeks of the pandemic.

1.2.3 PRICE AND DEMAND

Let's suppose a situation of price and demand (very common in the industry). Demand models basically tell when we know the price of a certain product, the quantity of it available in the market.

Observation 1.2.6 (Positive Association)

The graphs in the first two examples are said to have **positive association**.

For products, when there is a huge amount of product, the price decreases and, when the price is too high, the amount available is too low. The model:

This model is given by the equation:

$$Q = 60,000P^{-2.5}$$

In this model we use a power function (which is basically the exponential function in essence, but many people who doesn't have mathematical background calls is *power function*).

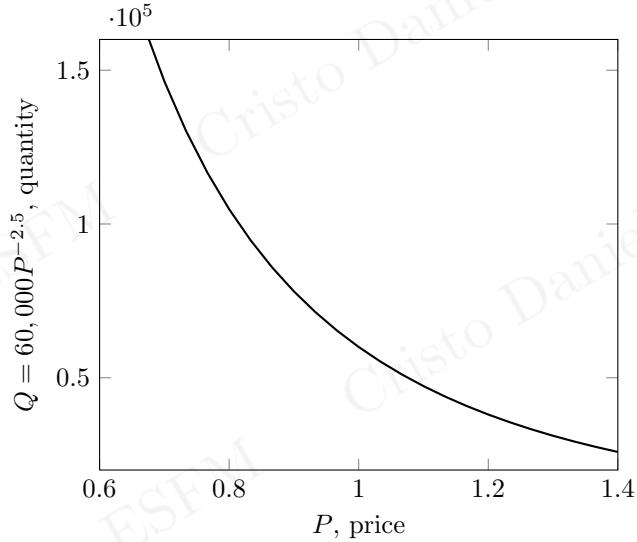


Figure 1.3: Price and Demand Model

Idea 1.2.1

One use of this model is to find what the optimal price for a product should be.

1.2.4 THE UPTAKE OF A PRODUCT

Definition 1.2.2 (Uptake)

The **uptake of a product**, often referred to as **product adoption** or **market uptake**, is *the process by which individuals or organizations learn about, start using, and ultimately integrate a new product or service into their routine life or business operations*.

The following describes the uptake of a product given the amount of years it has been on the market.

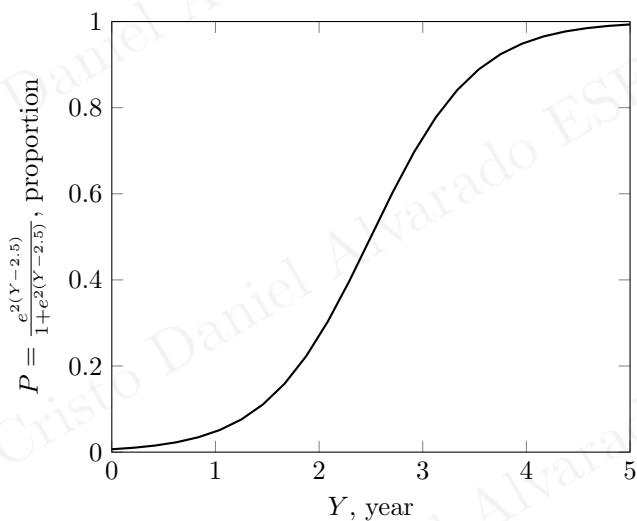


Figure 1.4: Model of the Uptake of a Product

This particular function is called a logistic function, and is given by:

$$P = \frac{e^{2(Y-2.5)}}{1 + e^{2(Y-2.5)}}$$

Here, Y is the number of years and, P is the proportion of target population with product.

Observation 1.2.7

This model has the potential to model a process where at the first stages we see a slow start (here, it's when target people start adopting the product), and then it has a fast grow that proceeds to slow as time goes by.

1.3 USE OF MODELS IN PRACTICE

There are four main usages of a model in the business environment:

- **Prediction.**
- **Forecasting.**
- **Optimization.**
- **Ranking and targeting.**

1.3.1 PREDICTION

Once we got a quantitative model is **prediction**. Basically is taking a model, putting an input and create a prediction.

Observation 1.3.1

The use of most quantitative models is for predictive analysis.

1.3.2 FORECASTING

When talking about forecasting we are talking about time series.

Definition 1.3.1 (Forecasting)

Forecasting is the *process of predicting future developments by analyzing past and present data and trends.*

Example 1.3.1

For example, with the models presented earlier, we can ask the following questions:

- How many people are expected to be infected in 6 weeks?
- Using a scheduling model, who is likely to turn up for their outpatient appointment?

This activity has often a lot to do in businesses and to do with resource planning.

1.3.3 OPTIMIZATION

How to maximize or minimize something?

1.3.4 RANKING AND TARGETING

When selling a product, we may be interested in which ones we would like to purchase. Since we cannot have a look at all the diamonds in the world, **identify targets of opportunity**. This is a ranking and targeting exercise.

Or, for example, if I am interested in buying, is useful to create a model to help classify places which I can buy.

1.4 HOW ARE MODELS USED IN PRACTICE

We use models in real-life scenarios in order to:

- Exploring what if scenarios (this is **called scenario planning**).
- Interpreting the coefficients in a model (what's the meaning behind **coefficients in model equations?**).

- Assessing how sensitive the model is to key-assumptions.

Definition 1.4.1 (Sensitivity Analysis)

A **sensitivity analysis** is the process where we check how the output of a model is sensitive to some of the assumptions made at the beginning.

Benefits of Modeling

Identify gaps in current understanding

Make assumptions explicit

Have well-defined description of the business process

Create an institution memory

Used as a decision **support** tool

Serendipitous insight generator

Table 1.1: Benefits of Modeling

1.5 KEY STEPS IN THE MODELING PROCESS

Every model is different but they share common features in the way the model was created (the workflow).

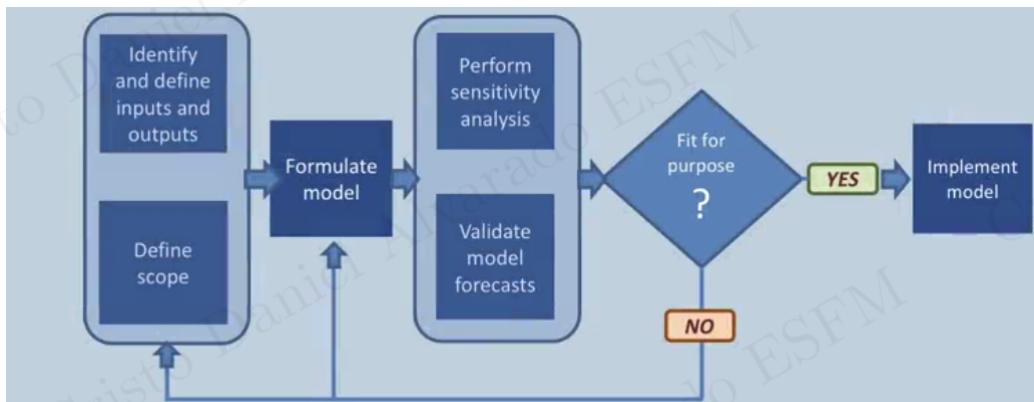


Figure 1.5: Overview of the Modeling Process

1. The first steps is always to **establish what the model is trying to predict**, and what are the **underlying variables** of it (which will help us to predict)?
What is the scope of the model? Which is, **where is it going to be applied?**
2. **Formulate the model.** Its the step where we understand the business process and all the mathematical ideas come into the process.
3. **Perform a sensitivity analysis** and validate **model forecast**.
4. Is the model fit for purpose? Is it suitable for its purpose?

Observation 1.5.1

Some teacher said: some wrong models are useful.

If something went wrong, we start over again. If the model accomplish its purpose, then we implement the model.

Idea 1.5.1

There is always a learning when a model doesn't work properly. We gain insight into what work and what doesn't work in the process.

Modeling is an iterative and evolutionary process.

1.6 VOCABULARY FOR MODELING

1.6.1 DATA DRIVEN VS. THEORY DRIVEN

There are basically two types of models: theoretical and data-driven. It's more like a spectrum than a certain type of model.

- **Theory:** Given a set of assumptions and relations, then what are the logical consequences?
- **Data:** Given a set of observations, how can we approximate the underlying process that generated them?

Example 1.6.1

These are two examples of questions that define a model:

- **Theory:** If we assume the markets are efficient, then what should the price of a stock option be?
- **Data:** I've separated out my profitable customers from the unprofitable ones. Now, what features are able to differentiate them?

1.6.2 DETERMINISTIC VS PROBABILISTIC

Given a set of inputs, the model always gives the same output or is it different instance from instance? This is the main difference between a deterministic and a probabilistic model, respectively.

1.6.3 STATIC VS DYNAMIC

So, in a static model, the model captures a single snapshot of the business process.

Example 1.6.2

Given a website's installed software base, what are the chances that it is compromised today?

And dynamic, in which the evolution of the process itself is of interest. The model describes the movement from state to state.

Example 1.6.3

Given a person's participation in a job training program, how long will it take until he/she finds a job, and, if they find one, for how long will they keep it?