



MONASH
University

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BUSINESS
SCHOOL

ETC3550/ETC5550

Applied forecasting

Week 5: Accuracy evaluation



Fitted values

- $\hat{y}_{t|t-1}$ is the forecast of y_t based on observations y_1, \dots, y_{t-1} .
- We call these “fitted values”.
- Sometimes drop the subscript: $\hat{y}_t \equiv \hat{y}_{t|t-1}$.
- Often not true forecasts since parameters are estimated on all data.

For example:

- $\hat{y}_t = \bar{y}$ for average method.
- $\hat{y}_t = y_{t-1} + (y_T - y_1)/(T - 1)$ for drift method.

Forecasting residuals

Residuals in forecasting: difference between observed value and its fitted value: $e_t = y_t - \hat{y}_{t|t-1}$.

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- 2 $\{e_t\}$ have mean zero. If they don't, then forecasts are biased.

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Useful properties (for distributions & prediction intervals)

- 3 $\{e_t\}$ have constant variance.
- 4 $\{e_t\}$ are normally distributed.

ACF of residuals

- We assume that the residuals are white noise (uncorrelated, mean zero, constant variance). If they aren't, then there is information left in the residuals that should be used in computing forecasts.
- So a standard residual diagnostic is to check the ACF of the residuals of a forecasting method.
- We *expect* these to look like white noise.

Ljung-Box tests

r_k = autocorrelation of residual at lag k

Test *whole set* of r_k values simultaneously.

$$Q^* = T(T+2) \sum_{k=1}^{\ell} (T-k)^{-1} r_k^2$$

where ℓ is max lag being considered and T is number of observations.

- My preferences: $\ell = 10$ for non-seasonal data, $h = 2m$ for seasonal data (where m is seasonal period).
- If data are WN, Q^* has χ^2 distribution with ℓ degrees of freedom.

Forecast distributions

- A forecast $\hat{y}_{T+h|T}$ is (usually) the mean of the conditional distribution $y_{T+h} \mid y_1, \dots, y_T$.
- Most time series models produce normally distributed forecasts.
- The forecast distribution describes the probability of observing any future value.

Forecast distributions

Assuming residuals are normal, uncorrelated, $\text{sd} = \hat{\sigma}$:

Mean: $y_{T+h|T} \sim N(\bar{y}, (1 + 1/T)\hat{\sigma}^2)$

Naïve: $y_{T+h|T} \sim N(y_T, h\hat{\sigma}^2)$

Seasonal naïve: $y_{T+h|T} \sim N(y_{T+h-m(k+1)}, (k+1)\hat{\sigma}^2)$

Drift: $y_{T+h|T} \sim N(y_T + \frac{h}{T-1}(y_T - y_1), h\frac{T+h}{T}\hat{\sigma}^2)$

where k is the integer part of $(h-1)/m$.

Note that when $h = 1$ and T is large, these all give the same approximate forecast variance: $\hat{\sigma}^2$.

Prediction intervals

- A prediction interval gives a region within which we expect y_{T+h} to lie with a specified probability.
- Assuming forecast errors are normally distributed, then a 95% PI is

$$\hat{y}_{T+h|T} \pm 1.96\hat{\sigma}_h$$

where $\hat{\sigma}_h$ is the st dev of the h -step distribution.

- When $h = 1$, $\hat{\sigma}_h$ can be estimated from the residuals.

Prediction intervals

- Point forecasts are often useless without a measure of uncertainty (such as prediction intervals).
- Prediction intervals require a stochastic model (with random errors, etc).
- For most models, prediction intervals get wider as the forecast horizon increases.
- Use `level` argument to control coverage.
- Check residual assumptions before believing them.
- Prediction intervals are usually too narrow due to unaccounted uncertainty.

Time series cross-validation

Traditional evaluation

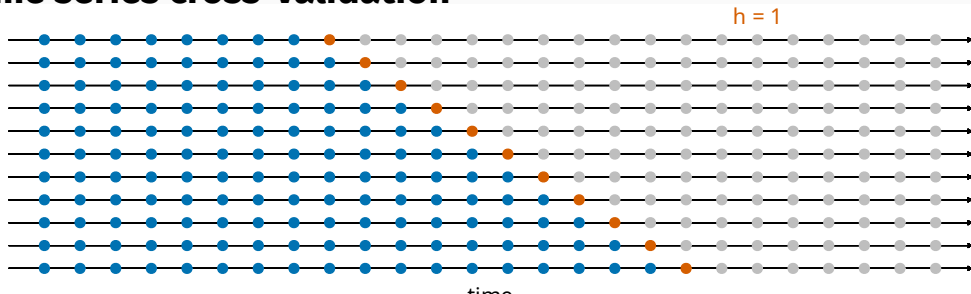


Time series cross-validation

Traditional evaluation



Time series cross-validation

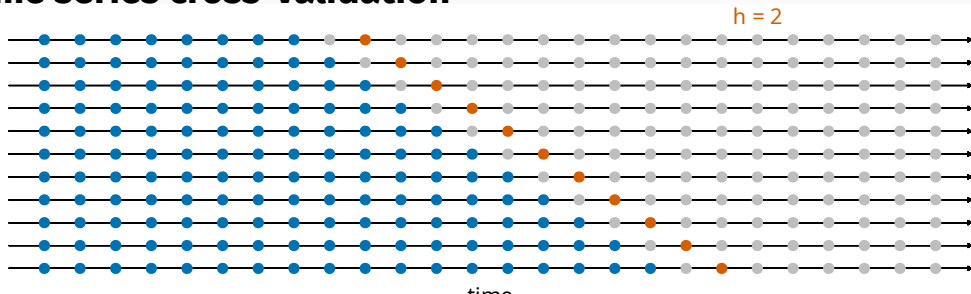


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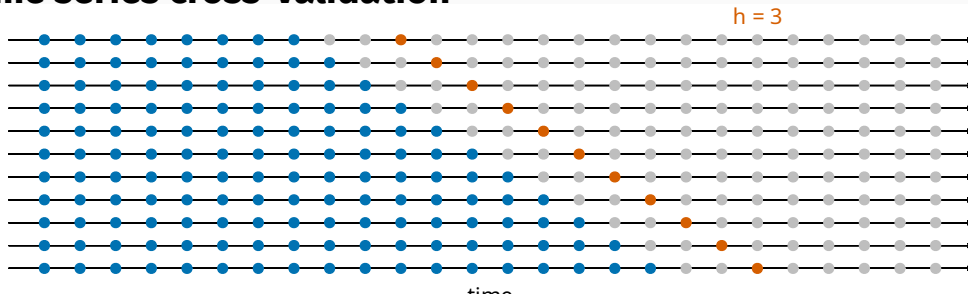


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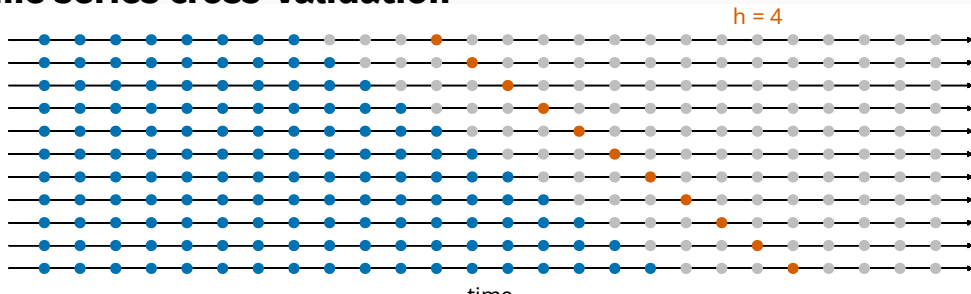


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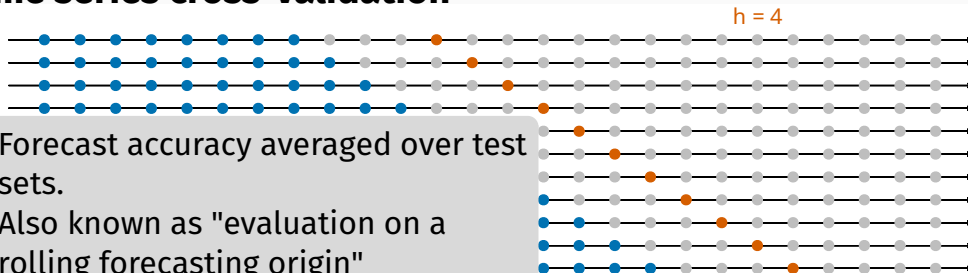


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Time series cross-validation



- Forecast accuracy averaged over test sets.
- Also known as "evaluation on a rolling forecasting origin"

Your turn

- 1 Create a training set for household wealth (`hh_budget`) by withholding the last four years as a test set.
- 2 Fit all the appropriate benchmark methods to the training set and forecast the periods covered by the test set.
- 3 Compute the accuracy of your forecasts. Which method does best?
- 4 Do the residuals from the best method resemble white noise?