

Table of Contents

PREFACE xi

ABOUT THE AUTHORS xv

CHAPTER 1 INTRODUCTION 1

- 1.1 Models and Modeling 1
 - 1.1.1 Why Study Modeling? 2
 - 1.1.2 Models in Business 2
 - 1.1.3 Models in Business Education 3
 - 1.1.4 Benefits of Business Models 3
- 1.2 The Role of Spreadsheets 4
 - 1.2.1 Risks of Spreadsheet Use 5
 - 1.2.2 Challenges for Spreadsheet Users 6
 - 1.2.3 Background Knowledge for Spreadsheet Modeling 7
- 1.3 The Real World and the Model World 7
- 1.4 Lessons from Expert and Novice Modelers 9
 - 1.4.1 Expert Modelers 9
 - 1.4.2 Novice Modelers 11
- 1.5 Organization of the Book 12
- 1.6 Summary 13
 - Suggested Readings 14

CHAPTER 2 MODELING IN A PROBLEM-SOLVING FRAMEWORK 15

- 2.1 Introduction 15
- 2.2 The Problem-Solving Process 16
 - 2.2.1 Some Key Terms 16
 - 2.2.2 The Six-Stage Problem-Solving Process 18
 - 2.2.3 Mental Models and Formal Models 23
- 2.3 Influence Charts 24
 - 2.3.1 A First Example 25
 - 2.3.2 An Income Statement as an Influence Chart 27
 - 2.3.3 Principles for Building Influence Charts 27
 - 2.3.4 Two Additional Examples 28
- 2.4 Craft Skills for Modeling 31
 - 2.4.1 Simplify the Problem 33
 - 2.4.2 Break the Problem into Modules 34
 - 2.4.3 Build a Prototype and Refine It 35
 - 2.4.4 Sketch Graphs of Key Relationships 38
 - 2.4.5 Identify Parameters and Perform Sensitivity Analysis 39
 - 2.4.6 Separate the Creation of Ideas from Their Evaluation 41
 - 2.4.7 Work Backward from the Desired Answer 42
 - 2.4.8 Focus on Model Structure, not on Data Collection 43
- 2.5 Summary 45
 - Suggested Readings 46
 - Exercises 46

CHAPTER 3 SPREADSHEET ENGINEERING 49

- 3.1 Introduction 49
- 3.2 Designing a Spreadsheet 51
 - 3.2.1 Sketch the Spreadsheet 51
 - 3.2.2 Organize the Spreadsheet into Modules 52
 - 3.2.3 Start Small 53
 - 3.2.4 Isolate Input Parameters 54
 - 3.2.5 Design for Use 54
 - 3.2.6 Keep It Simple 54
 - 3.2.7 Design for Communication 55
 - 3.2.8 Document Important Data and Formulas 55
- 3.3 Designing a Workbook 57
 - 3.3.1 Use Separate Worksheets to Group Similar Kinds of Information 58
 - 3.3.2 Design Workbooks for Ease of Navigation and Use 59
 - 3.3.3 Design a Workbook as a Decision-Support System 60
- 3.4 Building a Workbook 62
 - 3.4.1 Follow a Plan 62
 - 3.4.2 Build One Worksheet or Module at a Time 62
 - 3.4.3 Predict the Outcome of Each Formula 62
 - 3.4.4 Copy and Paste Formulas Carefully 62
 - 3.4.5 Use Relative and Absolute Addressing to Simplify Copying 62
 - 3.4.6 Use the Function Wizard to Ensure Correct Syntax 63
 - 3.4.7 Use Range Names to Make Formulas Easy to Read 63
 - 3.4.8 Choose Input Data to Make Errors Stand Out 64
- 3.5 Testing a Workbook 64
 - 3.5.1 Check That Numerical Results Look Plausible 64
 - 3.5.2 Check That Formulas Are Correct 65
 - 3.5.3 Test That Model Performance Is Plausible 68
- 3.6 Summary 68
 - Suggested Readings 69
 - Exercises 69

CHAPTER 4 ANALYSIS USING SPREADSHEETS 71

- 4.1 Introduction 71
- 4.2 Base-case Analysis 72
- 4.3 What-if Analysis 72
 - 4.3.1 Benchmarking 73
 - 4.3.2 Scenarios 74
 - 4.3.3 Parametric Sensitivity 77
 - 4.3.4 Tornado Charts 79
- 4.4 Breakeven Analysis 81
- 4.5 Optimization Analysis 83

viii TABLE OF CONTENTS

4.6 Simulation and Risk Analysis 84
 4.7 Summary 85
 Exercises 85

CHAPTER 5 DATA EXPLORATION AND PREPARATION 89

5.1 Introduction 89
 5.2 Dataset Structure 90
 5.3 Types of Data 93
 5.4 Data Exploration 93
 5.4.1 Understand the Data 94
 5.4.2 Organize and Subset the Data 94
 5.4.3 Examine Individual Variables Graphically 98
 5.4.4 Calculate Summary Measures for Individual Variables 99
 5.4.5 Examine Relationships among Variables Graphically 101
 5.4.6 Examine Relationships among Variables Numerically 105
 5.5 Data Preparation 109
 5.5.1 Handling Missing Data 109
 5.5.2 Handling Errors and Outliers 111
 5.5.3 Binning Continuous Data 111
 5.5.4 Transforming Categorical Data 111
 5.5.5 Functional Transformations 112
 5.5.6 Normalizations 113
 5.6 Summary 113
 Suggested Readings 114
 Exercises 114

CHAPTER 6 CLASSIFICATION AND PREDICTION METHODS 117

6.1 Introduction 117
 6.2 Preliminaries 117
 6.2.1 The Data-Mining Process 118
 6.2.2 The Problem of Overfitting 118
 6.2.3 Partitioning the Dataset 120
 6.2.4 Measures of Model Quality 120
 6.2.5 Variable Selection 125
 6.2.6 Setting the Cutoff in Classification 126
 6.3 Classification and Prediction Trees 127
 6.3.1 Classification Trees 128
 6.3.2 An Application of Classification Trees 130
 6.3.3 Prediction Trees 137
 6.3.4 An Application of Prediction Trees 138
 6.3.5 Ensembles of Trees 141
 6.4 Additional Algorithms for Classification 143
 6.4.1 Logistic Regression 144
 6.4.2 Naïve Bayes 150
 6.4.3 *k*-Nearest Neighbors 158
 6.4.4 Neural Networks 162
 6.5 Additional Algorithms for Prediction 169
 6.5.1 Multiple Linear Regression 169
 6.5.2 *k*-Nearest Neighbors 177
 6.5.3 Neural Networks 178
 6.6 Strengths and Weaknesses of Algorithms 181
 6.7 Practical Advice 182
 6.8 Summary 183
 Suggested Readings 184
 Exercises 184

CHAPTER 7 SHORT-TERM FORECASTING 187

7.1 Introduction 187
 7.2 Forecasting with Time-Series Models 187
 7.2.1 The Moving-Average Model 188
 7.2.2 Measures of Forecast Accuracy 191
 7.3 The Exponential Smoothing Model 192
 7.4 Exponential Smoothing with a Trend 196
 7.5 Exponential Smoothing with Trend and Cyclical Factors 198
 7.6 Using XLMiner for Short-Term Forecasting 202
 7.7 Summary 202
 Suggested Readings 203
 Exercises 203

CHAPTER 8 NONLINEAR OPTIMIZATION 207

8.1 Introduction 207
 8.2 An Optimization Example 208
 8.2.1 Optimizing Q1 208
 8.2.2 Optimization Over All Four Quarters 210
 8.2.3 Incorporating the Budget Constraint 211
 8.3 Building Models for Solver 213
 8.3.1 Formulation 213
 8.3.2 Layout 214
 8.3.3 Interpreting Results 215
 8.4 Model Classification and the Nonlinear Solver 215
 8.5 Nonlinear Programming Examples 217
 8.5.1 Facility Location 217
 8.5.2 Revenue Maximization 219
 8.5.3 Curve Fitting 221
 8.5.4 Economic Order Quantity 225
 8.6 Sensitivity Analysis for Nonlinear Programs 227
 8.7 The Portfolio Optimization Model 231
 8.8 Summary 234
 Suggested Readings 234
 Exercises 234

CHAPTER 9 LINEAR OPTIMIZATION 239

9.1 Introduction 239
 9.1.1 Linearity 239
 9.1.2 Simplex Algorithm 240
 9.2 Allocation Models 241
 9.2.1 Formulation 241
 9.2.2 Spreadsheet Model 242
 9.2.3 Optimization 244
 9.3 Covering Models 246
 9.3.1 Formulation 246
 9.3.2 Spreadsheet Model 247
 9.3.3 Optimization 247
 9.4 Blending Models 248
 9.4.1 Blending Constraints 249
 9.4.2 Formulation 251
 9.4.3 Spreadsheet Model 252
 9.4.4 Optimization 252
 9.5 Sensitivity Analysis for Linear Programs 253
 9.5.1 Sensitivity to Objective Function Coefficients 254
 9.5.2 Sensitivity to Constraint Constants 255
 9.6 Patterns in Linear Programming Solutions 258
 9.6.1 Identifying Patterns 258
 9.6.2 Further Examples 260
 9.6.3 Review 264

9.7 Data Envelopment Analysis 265
 9.8 Summary 269
 Suggested Readings 270
 Exercises 270
 Appendix 9.1 The Solver Sensitivity Report 274

CHAPTER 10 OPTIMIZATION OF NETWORK MODELS 277

10.1 Introduction 277
 10.2 The Transportation Model 277
 10.2.1 Flow Diagram 278
 10.2.2 Model Formulation 278
 10.2.3 Spreadsheet Model 279
 10.2.4 Optimization 280
 10.2.5 Modifications to the Model 281
 10.2.6 Sensitivity Analysis 282
 10.3 Assignment Model 286
 10.3.1 Model Formulation 287
 10.3.2 Spreadsheet Model 287
 10.3.3 Optimization 288
 10.3.4 Sensitivity Analysis 288
 10.4 The Transshipment Model 289
 10.4.1 Formulation 290
 10.4.2 Spreadsheet Model 291
 10.4.3 Optimization 292
 10.4.4 Sensitivity Analysis 293
 10.5 A Standard Form for Network Models 293
 10.6 Network Models with Yields 295
 10.6.1 Yields as Reductions in Flow 295
 10.6.2 Yields as Expansions in Flow 297
 10.6.3 Patterns in General Network Models 300
 10.7 Network Models for Process Technologies 301
 10.7.1 Formulation 301
 10.7.2 Spreadsheet Model 303
 10.7.3 Optimization 304
 10.8 Summary 304
 Exercises 305

CHAPTER 11 INTEGER OPTIMIZATION 309

11.1 Introduction 309
 11.2 Integer Variables and the Integer Solver 310
 11.3 Binary Variables and Binary Choice Models 312
 11.3.1 The Capital Budgeting Problem 312
 11.3.2 The Set Covering Problem 315
 11.4 Binary Variables and Logical Relationships 316
 11.4.1 Relationships Among Projects 317
 11.4.2 Linking Constraints and Fixed Costs 319
 11.4.3 Threshold Levels and Quantity Discounts 323
 11.5 The Facility Location Model 324
 11.5.1 The Capacitated Problem 325
 11.5.2 The Uncapacitated Problem 327
 11.5.3 The Assortment Model 329
 11.6 Summary 330
 Suggested Readings 331
 Exercises 331

CHAPTER 12 OPTIMIZATION OF NONSMOOTH MODELS 335

12.1 Introduction 335
 12.2 Features of the Evolutionary Solver 335
 12.3 Curve Fitting (Revisited) 338

12.4 The Advertising Budget Problem (Revisited) 339
 12.5 The Capital Budgeting Problem (Revisited) 342
 12.6 The Fixed Cost Problem (Revisited) 344
 12.7 The Machine-Sequencing Problem 345
 12.8 The Traveling Salesperson Problem 347
 12.9 Group Assignment 350
 12.10 Summary 352
 Exercises 352

CHAPTER 13 DECISION ANALYSIS 357

13.1 Introduction 357
 13.2 Payoff Tables and Decision Criteria 358
 13.2.1 Benchmark Criteria 358
 13.2.2 Incorporating Probabilities 359
 13.3 Using Trees to Model Decisions 361
 13.3.1 Decision Trees 362
 13.3.2 Decision Trees for a Series of Decisions 364
 13.3.3 Principles for Building and Analyzing Decision Trees 367
 13.3.4 The Cost of Uncertainty 368
 13.4 Using Decision Tree Software 369
 13.4.1 Solving a Simple Example with Decision Tree 370
 13.4.2 Sensitivity Analysis with Decision Tree 371
 13.4.3 Minimizing Expected Cost with Decision Tree 373
 13.5 Maximizing Expected Utility With Decision Tree 375
 13.6 Summary 378
 Suggested Readings 378
 Exercises 378

CHAPTER 14 MONTE CARLO SIMULATION 383

14.1 Introduction 383
 14.2 A Simple Illustration 384
 14.3 The Simulation Process 386
 14.3.1 Base-Case Model 387
 14.3.2 Sensitivity Analysis 388
 14.3.3 Specifying Probability Distributions 390
 14.3.4 Specifying Outputs 391
 14.3.5 Setting Simulation Parameters 391
 14.3.6 Analyzing Simulation Outputs 391
 14.4 Corporate Valuation Using Simulation 395
 14.4.1 Base-Case Model 396
 14.4.2 Sensitivity Analysis 398
 14.4.3 Selecting Probability Distributions 399
 14.4.4 Simulation Analysis 399
 14.4.5 Simulation Sensitivity 402
 14.5 Option Pricing Using Simulation 404
 14.5.1 The Logic of Options 405
 14.5.2 Modeling Stock Prices 405
 14.5.3 Pricing an Option 408
 14.5.4 Sensitivity to Volatility 410
 14.5.5 Simulation Precision 410
 14.6 Selecting Uncertain Parameters 411
 14.7 Selecting Probability Distributions 413
 14.7.1 Empirical Data and Judgmental Data 413
 14.7.2 Six Essential Distributions 414
 14.7.3 Fitting Distributions to Data 418
 14.8 Ensuring Precision in Outputs 420
 14.8.1 Illustrations of Simulation Error 420
 14.8.2 Precision versus Accuracy 421
 14.8.3 An Experimental Method 422

X TABLE OF CONTENTS

14.8.4 Precision Using the MSE 423
 14.8.5 Simulation Error in a Decision Context 423
 14.9 Interpreting Simulation Outcomes 424
 14.9.1 Simulation Results 424
 14.9.2 Displaying Results on the Spreadsheet 426
 14.10 When to Simulate and When Not To Simulate 426
 14.11 Summary 428
 Suggested Readings 428
 Exercises 429

CHAPTER 15 OPTIMIZATION IN SIMULATION 435

15.1 Introduction 435
 15.2 Optimization with One or Two Decision Variables 435
 15.2.1 Base-case Model 436
 15.2.2 Grid Search 438
 15.2.3 Optimizing using Simulation Sensitivity 439
 15.2.4 Optimizing using Solver 442
 15.3 Stochastic Optimization 442
 15.3.1 Optimization of the Base-Case Model 442
 15.3.2 A Portfolio Optimization Problem 445
 15.4 Chance Constraints 448
 15.5 Two-Stage Problems with Recourse 453
 15.6 Summary 457
 Suggested Readings 458
 Exercises 458

MODELING CASES 463

APPENDIX 1 BASIC EXCEL SKILLS 479

Introduction 479
 Excel Prerequisites 479
 The Excel Window 480
 Configuring Excel 482
 Manipulating Windows and Sheets 483
 Navigation 484
 Selecting Cells 485

Entering Text and Data 485
 Editing Cells 486
 Formatting 487
 Basic Formulas 488
 Basic Functions 489
 Charting 493
 Printing 495
 Help Options 496
 Keyboard Shortcuts 497
 Cell Comments 497
 Naming Cells and Ranges 499
 Some Advanced Tools 502
 R1C1 Reference Style 502
 Mixed Addresses 503
 Advanced Functions 503

APPENDIX 2 MACROS AND VBA 507

Introduction 507
 Recording a Macro 507
 Editing a Macro 510
 Creating a User-Defined Function 512
 Suggested Readings 514

APPENDIX 3 BASIC PROBABILITY CONCEPTS 515

Introduction 515
 Probability Distributions 515
 Examples of Discrete Distributions 518
 Examples of Continuous Distributions 519
 Expected Values 521
 Cumulative Distribution Functions 522
 Tail Probabilities 523
 Variability 524
 Sampling 525

INDEX 529
