Brief Contents

CHAPTER 1  INTRODUCTION  1
CHAPTER 2  MODELING IN A PROBLEM-SOLVING FRAMEWORK  15
CHAPTER 3  SPREADSHEET ENGINEERING  49
CHAPTER 4  ANALYSIS USING SPREADSHEETS  71
CHAPTER 5  DATA EXPLORATION AND PREPARATION  89
CHAPTER 6  CLASSIFICATION AND PREDICTION METHODS  117
CHAPTER 7  SHORT-TERM FORECASTING  187
CHAPTER 8  NONLINEAR OPTIMIZATION  207
CHAPTER 9  LINEAR OPTIMIZATION  239
CHAPTER 10  OPTIMIZATION OF NETWORK MODELS  277
CHAPTER 11  INTEGER OPTIMIZATION  309
CHAPTER 12  OPTIMIZATION OF NONSMOOTH MODELS  335
CHAPTER 13  DECISION ANALYSIS  357
CHAPTER 14  MONTE CARLO SIMULATION  383
CHAPTER 15  OPTIMIZATION IN SIMULATION  435

MODELING CASES  463

APPENDICES

APPENDIX 1  479
APPENDIX 2  507
APPENDIX 3  515
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
# 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
TABLE OF CONTENTS

CHAPTER 9  DATA ENVELOPMENT ANALYSIS  265
9.1 Data Envelopment Analysis 265
9.2 Summary 269
9.3 Suggested Readings 270
9.4 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
10.9 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
11.7 Suggested Readings 331
11.8 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
12.11 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
13.7 Suggested Readings 378
13.8 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
14.8 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