

CONTENTS

PREFACE xxi

1 Introduction to Decision Analysis 1

Why Are Decisions Hard? 3

Why Study Decision Analysis? 5

Subjective Judgments and Decision Making 7

The Decision Analysis Process 8

Requisite Decision Models 11

Where Is Decision Analysis Used? 11

Where Does the Software Fit In? 12

Where Are We Going from Here? 14

Summary 14

Questions and Problems 15

CASE STUDIES Commercial Space Travel 16

Dupont and Chlorofluorocarbons 17

Choosing a Vice-Presidential Candidate 17

References 18

Epilogue 19

SECTION 1 Modeling Decisions 21

2 Elements of Decision Problems 23

Values and Objectives 23

Making Money: A Special Objective 24

Values and the Current Decision Context 25

Decisions to Make 27

Sequential Decisions 28

Uncertain Events 29

Consequences 31

The Time Value of Money: A Special Kind of Trade-Off 33

Summary 40

Questions and Problems 40

CASE STUDIES The Value of Patience 42

Early Bird, Inc. 43

References 44

Epilogue 45

3 Structuring Decisions 46

Structuring Values 47

Fundamental and Means Objectives 49

Getting the Decision Context Right 53

Structuring Decisions: Influence Diagrams 56

Influence Diagrams and the Fundamental Objectives Hierarchy 58

Using Arcs to Represent Relationships 60

Some Basic Influence Diagrams 61

The Basic Risky Decision 61

Imperfect Information 62

Sequential Decisions 65

Intermediate Calculations 67

Constructing an Influence Diagram 69

Some Common Mistakes 71

Multiple Representations and Requisite Models 72

Structuring Decisions: Decision Trees 73

Decision Trees and the Objectives Hierarchy 75

Basic Decision Trees 76

The Basic Risky Decision 76

Imperfect Information 77

Sequential Decisions 78

Decision Trees and Influence Diagrams Compared 79

Decision Details: Defining Elements of the Decision 80

More Decision Details: Cash Flows and Probabilities 82

Defining Measurement Scales for Fundamental Objectives 83

Using PrecisionTree for Structuring Decisions 89

Constructing a Decision Tree for the Research-and-Development
Decision 89

Constructing an Influence Diagram for the Basic Risky Decision 97

Summary 104

Exercises 105

Questions and Problems 107

CASE STUDIES Prescribed Fire 114

The SS *Kuniang* 114

The Hillblom Estate, Part I 115

References 116

Epilogue 117

4 Making Choices 118

Decision Trees and Expected Monetary Value 122

Solving Influence Diagrams: Overview 127

Solving Influence Diagrams: The Details

Online only at www.cengagebrain.com

Risk Profiles 129

Cumulative Risk Profiles 133

Dominance: An Alternative to EMV 135

Making Decisions with Multiple Objectives 139

Analysis: One Objective at a Time 140

Subjective Ratings for Constructed Attribute Scales 142

Assessing Trade-Off Weights 143

Analysis: Expected Values and Risk Profiles for Two Objectives 145

Decision Analysis Using PrecisionTree 147

Decision Trees 148

Influence Diagrams 154

Multiple-Attribute Models 158

Summary 162

Exercises 162

Questions and Problems 164

CASE STUDIES Southern Electronics, Part I 170

Southern Electronics, Part II 170

Strenlar 171

Job Offers 172

SS Kuniang, Part II 173

Marketing Specialists, Ltd. 174

References 176

Epilogue 176

5 Sensitivity Analysis 177

Sensitivity Analysis: A Modeling Approach 180

Problem Identification and Structure 180

One-Way Sensitivity Analysis: Sensitivity Graphs 188

One-Way Sensitivity Analysis: Tornado Diagrams 191

Dominance Considerations 194

Two-Way Sensitivity Analysis 196

Sensitivity to Probabilities 200

Sensitivity to Probabilities—House-hunting	203
Sensitivity Analysis in Action	210
Sensitivity Analysis: A Built-In Irony	212
Sensitivity Analysis Using Excel [®] and PrecisionTree	212
Summary	223
Exercises	223
Questions and Problems	224
CASE STUDIES	
Dumond International, Part I	228
Strenlar, Part II	229
Job Offers, Part II	230
The Hillblom Estate, Part II	230
Manpads	230
References	232

6 Organizational Use of Decision Analysis 233

The Decision-Making Process	234
A Six-Step Decision Process: The Lacing Diagram	234
Organizational Issues in Enhancing Creativity and Enabling Choices	239
Developing Alternatives: Understanding the Creative Process	241
Value-Focused Thinking for Creating Alternatives	243
Fundamental Objectives	243
Means Objectives	244
Strategy Tables	246
Blocks to Creativity and Additional Creativity Techniques	
Online only at www.cengagebrain.com	
Managing and Monitoring the Six-Step Decision Process	254
Other Examples	255
Summary	256
Questions and Problems	257
CASE STUDY Eastman Kodak	258
References	259
Epilogue	260

Section 1 Cases 261

Athens Glass Works	261
Integrated Siting Systems, Inc.	263
International Guidance and Controls	266
George's T-shirts	267

7 Probability Basics 271

- A Little Probability Theory 271
- Venn Diagrams 272
- More Probability Formulas 273
- PrecisionTree[®] and Bayes' Theorem 279
- Uncertain Quantities 279
 - Discrete Probability Distributions 280
 - Expected Value 282
 - Variance and Standard Deviation 285
 - Continuous Probability Distributions 288
 - Stochastic Dominance Revisited 290
 - Probability Density Functions 290
 - Expected Value, Variance, and Standard Deviation:
The Continuous Case 291
- Correlation and Covariance for Measuring Dependence
Online only at www.cengagebrain.com
- Oil Wildcatting 293
- John Hinckley's Trial 299
- Summary 301
- Exercises 301
- Questions and Problems 305
- CASE STUDIES
 - Decision Analysis Monthly 308
 - Screening for Colorectal Cancer 309
 - AIDS 310
 - Discrimination and the Death Penalty 312
- References 313
- Epilogue 313

8 Subjective Probability 315

- Uncertainty and Public Policy 315
- Probability: A Subjective Interpretation 317
- Assessing Discrete Probabilities 319
- Assessing Continuous Probabilities 323
- Heuristics and Biases in Probability Assessment 330
 - Memory Biases 332
 - Statistical Biases 334
 - Confidence Biases 336
 - Adjustment Heuristics and Biases 336

Motivational Bias	338
Heuristics and Biases: Implications	338
Decomposition and Probability Assessment	339
Experts and Probability Assessment: Pulling It All Together	344
Constructing Distributions Using @RISK	350
Coherence and the Dutch Book	
Online only at www.cengagebrain.com	
Summary	354
Exercises	355
Questions and Problems	356
CASE STUDIES	Assessing Cancer Risk—From Mouse to Man 361
	Breast Implants 362
	The Space Shuttle <i>Challenger</i> 363
References	365
Epilogue	366

9 Theoretical Probability Models 367

The Binomial Distribution	369
The Poisson Distribution	377
The Exponential Distribution	382
The Normal Distribution	385
The Triangular Distribution	390
The Beta Distribution	392
Summary	399
Exercises	400
Questions and Problems	401
CASE STUDIES	Overbooking 411
	Earthquake Prediction 412
	Municipal Solid Waste 414
References	416
Epilogue	417

10 Using Data 418

Using Data to Construct Probability Distributions	418
Empirical CDFs	422
Using Data to Fit Theoretical Probability Models	428
Using @RISK to Fit Distributions to Data	431
Using Data to Model Relationships	443
The Regression Approach	447

Assumption 1	447
Assumption 2	450
Estimation: The Basics	452
Estimation: More than One Conditioning Variable	459
Regression Analysis and Modeling: Some Do's and Don't's	465
Regression Analysis: Some Bells and Whistles	467
Regression Modeling: Decision Analysis versus Statistical Inference	470
An Admonition: Use with Care	471

Natural Conjugate Distributions

Online only at www.cengagebrain.com

Summary	471
Exercises	471
Questions and Problems	472
CASE STUDIES TACO Shells	479
References	480
Epilogue: Solar Trash Compactors	480

11 Simulation 481

Mechanics of Simulation	483
Sampling from Probability Distributions	486
Simulation Models	488
Simulating the Model	492
Simulation vs. Decision Trees	497
Examples of Simulation Models	501
Probability Models	501
A Capital Budgeting Model	504
Stock Price Model	506
Simulating Spreadsheet Models Using @RISK	511
Correlations Among Random Variables	516
Sequential Simulations	520
Simulation, Decision Trees, and Influence Diagrams	522
Summary	523
Exercises	523
Questions and Problems	524
CASE STUDIES Choosing a Manufacturing Process	526
La Hacienda Musa	527
Overbooking, Part III	529
References	529
Epilogue	530

12 Value of Information 531

Value of Information: Some Basic Ideas	532
Probability and Perfect Information	532
The Expected Value of Information	535
Expected Value of Perfect Information	536
Expected Value of Imperfect Information	538
Value of Information in Complex Problems	544
Value of Information, Sensitivity Analysis, and Structuring	545
Value of Information and Nonmonetary Objectives	547
Value of Information and Experts	548
Calculating EVPI and EVII with PrecisionTree	548
EVPI	548
Influence Diagrams	549
Decision Trees	550
EVII	552
Summary	553
Exercises	554
Questions and Problems	555
CASE STUDIES	
Texaco–Pennzoil Revisited	558
Medical Tests	558
Dumond International Part II	559
References	559

13 Real Options 561

Option Basics	563
Financial Options: A Brief Tutorial	564
Real Options	568
An Approach to Valuing Real Options	570
Discrete Uncertainties and Choices: Decision Trees	570
Continuous Uncertainties and Discrete Choices: Spreadsheet Simulation	573
Optionality and Proteiz	574
A Trigger Value for Deciding	577
Valuing the Abandon Option	578
Valuing the Scale-Up Option	581
Review of the Approach for Continuous Uncertainties	588
Comparison with Real Option Valuation from Financial Theory	588
What Discount Rate?	589
Finding Optimal Decision Values Using RISK Optimizer	590

Summary	595
Exercises	595
Questions and Problems	597
References	602

Section 2 Cases 603

LAC Leman Festival De La Musique (A)	603
LAC Leman Festival De La Musique (B)	605
Sprigg Lane (A)	606
APPSHOP, Inc.	614
Calambra Olive Oil (A)	615
Calambra Olive Oil (B)	626
SCOR-eSTORE.COM	629

SECTION 3 Modeling Preferences 635

14 Risk Attitudes 637

Risk	639
Risk Attitudes	641
Investing in the Stock Market, Revisited	643
Expected Utility, Certainty Equivalents, and Risk Premiums	645
Keeping Terms Straight	649
Utility Function Assessment	649
Assessment Using Certainty Equivalents	650
Assessment Using Probabilities	652
Assessment Using Tradeoffs	653
Gambles, Lotteries, and Investments	654
Risk Tolerance and the Exponential Utility Function	654
Pitfalls in Utility Assessment: Biases in the CE, PE, and TO Methods	657
The Endowment Effect	658
Preference Reversals	658
Implications for Assessing Utilities	659
Modeling Preferences Using PrecisionTree	660
Decreasing and Constant Risk Aversion	664
Decreasing Risk Aversion	665
An Entrepreneurial Example	665
Constant Risk Aversion	667
Some Caveats	669
Summary	670
Exercises	670

Questions and Problems 672

CASE STUDIES Interplants, Inc. 680

Strenlar, Part III 681

References 681

Epilogue 682

15 Utility Axioms, Paradoxes, and Implications 683

Axioms for Expected Utility 684

Paradoxes 691

Hedonic Framing 696

Failure to Ignore Sunk Costs 697

Status Quo Bias 698

Implications 698

Implications for Utility Assessment 698

Managerial and Policy Implications 700

A Final Perspective 702

Summary 703

Exercises 703

Questions and Problems 704

CASE STUDIES The Life Insurance Game 708

Nuclear Power Paranoia 709

The Manager's Perspective 709

References 709

Epilogue 712

16 Conflicting Objectives I: Fundamental Objectives and the Additive Utility Function 713

Objectives and Attributes 716

Trading Off Conflicting Objectives: The Basics 718

Choosing an Automobile: An Example 718

The Additive Utility Function 720

Choosing an Automobile: Proportional Scores 721

Assessing Weights: Pricing Out the Objectives 722

Indifference Curves 724

Assessing Individual Utility Functions 725

Proportional Scores 726

Ratios 728

Standard Utility-Function Assessment 729

Assessing Weights 730

Pricing Out	730
Swing Weighting	731
Lottery Weights	734
Biases and Inconsistencies in Weight Assessment	736
Keeping Concepts Straight: Certainty versus Uncertainty	737
An Example: Library Choices	738
Using Software for Multiple-Objective Decisions	745
Summary	745
Exercises	746
Questions and Problems	747
CASE STUDIES	
The Satanic Verses	755
Dilemmas in Medicine	755
A Matter of Ethics	757
FDA and The Testing of Experimental Drugs	757
References	758
Epilogue	759

17 Conflicting Objectives II: Multiattribute Utility Models with Interactions 760

Multiattribute Utility Functions: Direct Assessment	761
Independence Conditions	763
Preferential Independence	763
Utility Independence	764
Determining Whether Independence Exists	765
Using Independence	767
Additive Independence	768
Substitutes and Complements	770
Assessing a Two-Attribute Utility Function	771
Three or More Attributes	
Online only at www.cengagebrain.com	
When Independence Fails	776
Multiattribute Utility in Action: BC Hydro	777
Summary	782
Exercises	782
Questions and Problems	783
CASE STUDY	
A Mining Investment Decision	786
References	788
Epilogue	788

Section 3 Cases 789

John Carter: Hedging 789

Sleepmore Mattress Manufacturing: Plant Consolidation 790

Susan Jones (A) 795

Susan Jones (B) 797

18 Conclusion and Further Reading 799

A Decision-Analysis Reading List 800

Decision Analysis 801

Behavioral Decision Making 802

AUTHOR INDEX 805

SUBJECT INDEX 807