RISK AND RELIABILITY IN
OPTIMIZATION UNDER UNCERTAINTY

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Decisions in the Face of Uncertain Outcomes

⇒ especially serious modeling challenges in optimization
appropriate formulation of constraints and objectives?

Asset management in finance:
a portfolio must be chosen with intelligent safeguarding
performance known at best from history and economic factors
the threat of losses cannot be eliminated

Logistics in operations research:
supplies must be stockpiled to meet demands
distribution and replacement expense should be kept at bay
demands and costs are random variables, but partly guesswork

Design problems in engineering:
a structure must be engineered to withstand various impacts
possible impacts can only be estimated
potential for failure must be kept low
Reliability of Structures in Engineering

Engineering areas that are affected:
civil, mechanical, electrical, manufacturing, mining, . . . .

Examples of structures:
buildings, bridges, tunnels, reservoirs/dams, vehicle frames,
ship hulls, airplane wings, offshore platforms . . .

Tasks that are influenced: design, maintenance, retrofit

Sources of uncertainty

- loads that a structure may experience in the future
earthquakes, floods, wind storms, impacts in crashes
- variability in materials utilized or encountered
unknown aspects of composition, imprecision in manufacture
- environmental and economic circumstances
climate effects, evolving demands in usage
Objectives and Constraints in Stochastic Optimization

Typical considerations:
- minimizing costs, maximizing performance
- keeping various good properties at adequate levels
- preventing bad properties from reaching dangerous levels

Helpful resources:
- statistical methodology in assessing uncertainty
- choosing good values of design variables
- organizing good routines of maintenance and inspection

Technical challenges:
- avoiding formulations that suffer from DISCONTINUITY
- promoting formulations that take advantage of CONVEXITY

→ all of this must be integrated with good modeling!
→ guidelines for that must be understood and incorporated!
A Stochastic Framework of Uncertainty

General “cost” expression in decision-making:
\[ c(x, v) \text{ with } x = \text{decision vector}, \ v = \text{data vector} \]
\[ x = (x_1, \ldots, x_n), \quad v = (v_1, \ldots, v_m) \]

Stochastic uncertainty:
\[ v \text{ is replaced by a random variable vector } V = (V_1, \ldots, V_m) \]
then the “cost” becomes a random variable:
\[ c(x) = c(x, V) \]

Key consequence:
the distribution of \( c(x) \) can only be \textit{shaped} by the choice of \( x \) but how then can constraints or minimization be understood?
Failure From a Standard Engineering Perspective

\[ X = c(x_1, \ldots, x_n; V_1, \ldots, V_r) = \text{a “cost” that signals “danger”} \]

Probability of failure: \( p_f = \text{prob}\{X > 0\} \)

- How to compute or at least estimate?
- How to cope with dependence on \( x_1, \ldots, x_n \) in optimization?
  
  both \( p_f \) and the threshold shift with changes in \( x_1, \ldots, x_n \)!

Troubles with this concept:

- poor mathematical behavior is a serious handicap
- failure probability ignores the degree of failure
Source of difficulties in modeling objectives and constraints

- nothing can be perfect, risks will almost always remain
- trade-offs must be contemplated between different risks
- preferences and intentions in handling risk must be articulated
- computational viability must be taken into account

Crucial issue for effectiveness:

How does the risk relate to the decision \((x_1, \ldots, x_n)\)?
What are the mathematical properties of this dependence?

“Coherent” approaches to quantifying “risk” must play a role
A Broad Pattern for Quantifying Risk

Risk measures: functionals $\mathcal{R}$ that “quantify the risk” in a random variable $X$ by a value $\mathcal{R}(X)$ (“risk” $\neq$ “uncertainty”)

Systematic prescription

Faced with an uncertain “cost” $c(x) = c(x, V)$ articulate it numerically as $\bar{c}(x) = \mathcal{R}(c(x))$ for a choice of risk measure $\mathcal{R}$

Constraints: keeping $c(x)$ “sufficiently” $\leq b$
modeled as: constraint $\bar{c}(x) = \mathcal{R}(c(x)) \leq b$

Objectives: keeping $c(x)$ “sufficiently low”
modeled as: minimizing $\bar{c}(x) = \mathcal{R}(c(x))$
$\Rightarrow$ finding lowest $b$ such that $\exists x$ with $c(x)$ “$\mathcal{R}$-sufficiently $\leq” b$

Supporting theory: exploration of examples and guidelines
but note: choosing $\mathcal{R}$ expresses a decision-maker’s preferences
Some Familiar Approaches Subject to Pros and Cons

[ random cost \( c(x) = c(x, V) \) reduced to a numerical cost \( \bar{c}(x) \) ]

Focusing on worst cases:
\[
\bar{c}(x) = \sup[c(x)] \quad [ \text{taking } \mathcal{R}(X) = \sup X \text{ (ess. sup)} ]
\]
then \( \bar{c}(x) \leq b \iff c(x) \leq b \) almost surely

Passing to expectations:
\[
\bar{c}(x) = \mu[c(x)] = E[c(x)] \quad [ \text{taking } \mathcal{R}(X) = \mu X = EX ]
\]
then \( \bar{c}(x) \leq b \iff c(x) \leq b \) “on average”

Adopting a safety margin:
\[
\bar{c}(x) = \mu[c(x)] + \lambda \sigma[c(x)] \quad [ \text{taking } \mathcal{R}(X) = \mu X + \lambda \sigma(X) ]
\]
then \( \bar{c}(x) \leq b \) unless in tail beyond \( \lambda \) standard deviations

Looking at quantiles:
\[
\bar{c}(x) = q_p[c(x)] \quad [ \text{taking } \mathcal{R}(X) = \text{quantile at level } p \in (0, 1) ]
\]
then \( \bar{c}(x) \leq b \iff \text{prob}\{c(x) \leq b\} \geq p \)
Quantiles and "Superquantiles": VaR and CVaR

$F_X = \text{cumulative distribution function for random variable } X$

**Quantile:** "value-at-risk" in finance

$q_p(X) = \text{VaR}_p(X) = F_X^{-1}(p)$

**Superquantile:** "conditional value-at-risk" in finance

$Q_p(X) = \text{CVaR}_p(X) = E[X | X \geq q_p(X)] = \frac{1}{1-p} \int_p^1 q_t(X) dt$

Replace quantiles by superquantiles in optimization?

take $\bar{c}(x) = Q_p(c(x))$ in objective and constraint modeling?

then $\bar{c}(x) \leq b \iff c(x) \leq b$ on average even in $p$-quantile-tail
Guidelines for Quantifying Risk in General

Key axioms for risk measures: \( R : \mathcal{L}^1(\Omega, \mathcal{A}, P) \to (-\infty, \infty] \)

(R1) \( R(C) = C \) for all constants \( C \)
(R2) convexity, \quad (R3) lower semicontinuity

Supplementary properties of interest:
(R4) positive homogeneity: \( R(\lambda X) = \lambda R(X) \) for \( \lambda > 0 \)
(R5) monotonicity: \( R(X) \leq R(X') \) when \( X \leq X' \)
(R6) aversity: \( R(X) > EX \) for nonconstant \( X \)

Coherent measure of risk: \( R \) satisfying (R1), (R2), (R3), (R5)
Averse measure of risk: \( R \) satisfying (R1), (R2), (R3), (R6)

Artzner et al. (2000) introduced coherency without aversity

Preservation of convexity under coherency of \( R \)
\( c(x) = c(x, V) \) convex in \( x \) \( \implies \) \( \tilde{c}(x) = R(c(x)) \) convex in \( x \)

a further advantage of coherency: it promotes dualizations
Coherency or its Absence

- $\mathcal{R}(X) = q_p(X) = \text{VaR}_p(X)$ fails (R2), (R3), and (R6)!
- $\mathcal{R}(X) = Q_p(X) = \text{CVaR}_p(X)$ satisfies all axioms
- $\mathcal{R}(X) = \sup X$ satisfies all axioms
- $\mathcal{R}(X) = \mu(X) = E[X]$ fails (R6) (coherency without aversity)
- $\mathcal{R}(X) = \mu(X) + \lambda \sigma(X), \lambda > 0$, fails (R5) (no monotonicity)

$\implies$ careful attention is needed in the choice of a risk measure!
Characterization of Coherent Risk Measures

**Dual formula for** $\mathcal{R}$

\[
\mathcal{R}(X) = \sup_{Q \in \mathcal{Q}} \{ E[XQ] - \mathcal{J}(Q) \}
\]

for some set $\mathcal{Q}$ of **probability densities** (i.e., $Q \geq 0, EQ = 1$) and some function $\mathcal{J}$ from $\mathcal{Q}$ to $\mathbb{R}$ such that $\inf_{Q \in \mathcal{Q}} \mathcal{J}(Q) = 0$

**Interpretation:** $Q$ stands for a prob. measure $P'$ contemplated as an **alternative** to the nominal prob. measure $P$ (having $Q \equiv 1$)

- $\mathcal{J} \equiv 0$ on $Q \iff \mathcal{R}(\lambda X) = \lambda \mathcal{R}(X)$ for $\lambda > 0$
- $\mathcal{J}(Q) = 0$ for $Q \equiv 1 \implies \mathcal{R}(X) \geq EX$
Utilizing superquantiles in place of quantiles in reliability
the “danger cost”: \( X = c(x_1, \ldots, x_n; V_1, \ldots, V_r) \)

Buffered probability of failure: \( P_f = \text{prob}\{X > q\} \)
with \( q \) determined so as to make \( E[X \mid X > q] = 0 \)!

Proposal: adjust failure modeling to \( P_f \) in place of \( p_f \)
safer by integrating tail information, and
easier also to work with in computation!
Failure Concept Relationships

\[ q_p(X) = F_X^{-1}(p), \quad Q_p(X) = \frac{1}{1-p} \int_p^1 q_s(X) \, ds \]

\( q_p(X) \) can depend poorly on \( p \), but \( Q_p(X) \) depends nicely on \( p \)

**failure modeling:**

- \( p_f \) determined by \( q_p(X) = 0, \; p = 1 - p_f \)
- \( P_f \) determined by \( Q_p(X) = 0, \; p = 1 - P_f \)
Some Practical Considerations

Key formula

\[ Q_p(X) = \min_{C \in \mathbb{R}} \left\{ C + \frac{1}{1-p} E \left[ \max\{0, X - C\} \right] \right\} \quad p \in (0, 1) \]

\[ q_p(X) = \text{argmin} \quad \text{(if unique, otherwise the lowest)} \]

Application to failure: \( X = c(x) = c(x, V) \), want \( \leq 0 \)

**ordinary probability of failure:** constraint \( p_f(c(x)) \leq 1 - p \)

- corresponds to having \( x \) satisfy \( q_p(c(x)) \leq 0 \)

**buffered probability of failure:** constraint \( P_f(c(x)) \leq 1 - p \)

- corresponds to having \( Q_p(c(x)) \leq 0 \), hence equivalently to having \( x \) and \( C \) satisfy \( C + \frac{1}{1-p} E \left[ \max\{0, c(x) - C\} \right] \leq 0 \)

**Monte Carlo sampling:** the expectation becomes a finite sum

**research issue:** what rules if the distribution of \( V \) depends on \( x \)?
Recall notation: \( c(x) = c(x, V) \) = an uncertain “cost”
= random variable depending on \( x \) and uncertain data \( V \)

Typical goal: keep the cost \( c(x) = c(x, V) \) as low as possible
(subject to constraints on the decision \( x \))

Interpretation: minimize \( \bar{c}(x) = R(c(x)) \) for a risk measure \( R \)
i.e., minimize \( b \) such that \( \exists x \) with \( c(x) - b \) \( R \)-sufficiently \( \leq 0 \)

Risk-neutral approach: minimize \( \bar{c}(x) = E[c(x)] \)
for \( b = E[c(x)] \), costs \( c(x) > b \) and \( c(x) < b \) average out

Risk-averse approaches: focus more on danger of cost overruns

Quantile version: minimize \( q_p(c(x)) \) for some \( p \in (0, 1) \)
min \( b \) with failure probability \( p_f(c(x) - b) < 1 - p \)

Superquantile version: minimize \( Q_p(c(x)) \) for some \( p \in (0, 1) \)
min \( b \) with buffered failure probability \( P_f(c(x) - b) < 1 - p \)
Some References


downloads:  www.math.washington.edu/~rtr/mypage.html