

Assignment 4

Below are three tasks that you shall try to solve. All questions put should be answered. Prepare your solutions in a nice format that can be easily read. You can help each other but there must be individual submissions (that are not just copies of one submission).

Your solutions should be submitted at latest on **Tuesday 17 December 2024.**

1. Assume some budget calculations depend on whether a certain cost will be at least SEK 120 000 or lower than this amount. A reasonable model for this cost is a normal distribution with standard deviation SEK 12 000 (independent of the mean) and a mean that can be modelled as normally distributed with mean 115 000 (SEK) and standard deviation 9 000 (SEK). No trend is anticipated for this cost and for the 6 previous periods the average cost was SEK 121 000.
Note that the hypotheses are about the actual cost, not the expected cost.
 - a) Show that the prior odds for the hypothesis that the cost will exceed SEK 120 000 (against the alternative that it will not) is about 0.59. [*hint: write the observed variable \tilde{x} as a sum of two independent random variables $\tilde{x} = \tilde{\mu} + \tilde{\varepsilon}$]*
 - b) Show that the Bayes factor (considering the average cost for the previous 6 periods) for the hypothesis that the cost will exceed SEK 120 000 (against the alternative that it will not) is about 1.63 [**Not** about 1.60 or about 1.70].
 - c) If the loss of accepting the hypothesis that the cost will be lower than SEK 120 000 while the opposite will be true is SEK 4 000, and the loss of accepting the hypothesis that the cost will be at least SEK 120 000 while the opposite will be true is SEK 6 000, which decision should be made for the budget (according to the rule of minimizing the expected loss)?
2. Consider a big box filled with an enormous amount of poker chips. You know that either 70% of the chips are red and the remainder blue, or 70% are blue and the remainder red. You must guess whether the big box has 70% red / 30% blue or 70% blue / 30% red. If you guess correctly, you win US\$5. If you guess incorrectly, you lose US\$3. Your prior probability that the big box contains 70% red / 30% blue is 0.40, and you are risk neutral in your decision making (i.e. your utility is linear in money).
 - a) If you could purchase sample information in the form of one draw of a chip from the big box, how much should you be willing to pay for it?

Assume now that the cost of sampling is US\$0.25 (i.e. 25 US cents) per draw.
 - b) What is the ENGS for a sample of 10 chips using a single-stage sampling plan.