REINFORCEMENT LEARNING AND STOCHASTIC OPTIMIZATION

A unified framework for sequential decisions

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PREFACE

Preface to *Reinforcement Learning and Stochastic Optimization: A unified framework for sequential decisions*

This books represents a lifetime of research into what I now call sequential decision problems, which dates to 1982 when I was introduced to the problem arising in truckload trucking (think of Uber/Lyft for trucks) where we have to choose which driver to assign to a load, and which loads to accept to move, given the high level of randomness in future customer demands, representing requests to move full truckloads of freight.

It took me 20 years to figure out a practical algorithm to solve this problem, which led to my first book (in 2007) on approximate dynamic programming, where the major breakthrough was the introduction of the post-decision state and the use of hierarchical aggregation for approximating value functions to solve these high-dimensional problems. However, I would argue today that the most important chapter in the book (and I recognized it at the time), was chapter 5 on how to model these problems, without any reference to algorithms to solve the problem. I identified five elements to a sequential decision problem, leading up to the objective function which was written

$$\max_{\pi} \mathbb{E}\left\{\sum_{t=0}^{T} C(S_t, X^{\pi}(S_t))|S_0\right\}.$$

It was not until the second edition (in 2011) that I realized that approximate dynamic programming (specifically, policies that depend on value functions) was not the only way to solve these problems; rather, there were four classes of policies, and only one used value functions. The 2011 edition of the book listed three of the four classes of policies

that are described in this book, but most of the book still focused on approximating value functions. It was not until a 2014 paper ("Clearing the Jungle of Stochastic Optimization") that I identified the four classes of policies I use now. Then, in 2016 I realized that the four classes of policies could be divided between two major strategies: the policy search strategy, where we search over a family of functions to find the one that works best, and the lookahead strategy, where we make good decisions by approximating the downstream impact of a decision made now.

Finally, I combined these ideas in a 2019 paper ("A Unified Framework for Stochastic Optimization" published in the European Journal for Operational Research) with a better appreciation of major classes of problems such as state-independent problems (the pure learning problems that include derivative-based and derivative-free stochastic search) and the more general state-dependent problems; cumulative and final reward objective functions; and the realization that any adaptive search algorithm was a sequential decision problem. The material in the 2019 paper is effectively the outline for this book.

This book builds on the 2011 edition of my approximate dynamic programming book, and includes a number of chapters (some heavily edited) from the ADP book. It would be nice to call this a third edition, but the entire framework of this book is completely different. "Approximate dynamic programming" is a term that still refers to making decisions based on the idea of approximating the downstream value of being in a state. After decades of working with this approach (which is still covered over a span of five chapters in this volume), I can now say with confidence that value function approximations, despite all the attention they have received, is a powerful methodology for a surprisingly narrow set of decision problems.

By contrast, I finally developed the confidence to claim that the four classes of policies are universal. This means that *any* method for making decisions will fall in one of these four classes, or a hybrid of two or more. This is a game changer, because it shifts the focus from an algorithm (the method for making decisions) to the model (specifically the optimization problem above, along with the state-transition function and the model of the exogenous information process). This means we write out the elements of a problem *before* we tackle the problem of designing policies to decisions. I call this:

Model first, then solve.

The communities working on sequential decision problems are very focused on methods, just as I was with my earlier work with approximate dynamic programming. The problem is that any particular method will be inherently limited to a narrow class of problems. In this book, I demonstrate how you can take a simple inventory problem, and then tweak the data to make each of the four classes work best.

This new approach has opened up an entirely new way of approaching a problem class that, in the last year of writing the book, I started calling "sequential decision analytics," which is any problem consisting of the sequence:

Decision, information, decision, information, ...

I allow decisions to range from binary (selling an asset) to discrete choices (favored in computer science) to the high-dimensional resource allocation problems popular in operations research. This approach starts with a problem, shifts to the challenging task of modeling uncertainty, and then finishes with designing policies to make decisions to optimize some metric. The approach is practical, scalable, and universally applicable.

It is exciting to be able to create a single framework that spans 15 different communities, and which represents every possible method for solving sequential decision problems. While having a common language to model any sequential decision problem, combined with the general approach of the four classes of policies, is clearly of value, this framework has been developed by standing on the shoulders of the giants who have laid the foundational work for all of these methods. I have had to make choices regarding the best notation and modeling conventions, but my framework is completely inclusive of all the methods that have been developed to solve these problems. Rather than joining the chorus of researchers promoting specific algorithmic strategies (as I once did), my goal is to raise the visibility of all methods, so that someone looking to solve a real problem is working with the biggest possible toolbox, rather than just the tools developed within a specific community.

A word needs to be said about the title of the book. As this is being written, there is a massive surge of interest in "reinforcement learning," which started as a form of approximate dynamic programming (I used to refer to ADP and RL as similar to American English and British English). However, as the RL community has grown and started working on harder problems, they encountered the same experience that I and everyone else working in ADP found: value function approximations are not a panacea. Not only is it the case that they often do not work, they usually do not work. As a result, the RL community branched out (just as I did) into other methods such as "policy gradient methods" (my "policy function approximations" or PFA), upper confidence bounding (a form of "cost function approximation" or CFA), the original Q-learning (which produces a policy based on "value function approximations" or VFA), and finally Monte Carlo tree search (a policy based on "direct lookahead approximations" or DLA). All of these methods are found in the second edition of Sutton and Barto's landmark book *Reinforcement Learning: An introduction*, but only as specific methods rather than general classes. This book takes the next step and identifies the general classes.

This evolution from one core method to all four classes of policies is being repeated among other fields that I came to call the "jungle of stochastic optimization." Stochastic search, simulation-optimization, and bandit problems all feature methods from each of the four classes of policies. Over time, I came to realize that all these fields (including reinforcement learning) were playing catchup to the grandfather of all of this work, which is optimal control (and stochastic control). The field of optimal control was the first to introduce and seriously explore the use of value function approximations (they call these cost-to-go functions), linear decision rules (a form of PFA), and the workhorse "model predictive control" (a great name for a simple rolling horizon procedure, which is a "direct lookahead approximation" in this book). I also found that my modeling framework was closest to that used in the optimal control literature, which was the first field to introduce the concept of a transition function, a powerful modeling device that has been largely overlooked by the other communities. I make a few small tweaks such as using state S_t instead of x_t, and decision x_t (widely used in the field of math programming) instead of u_t.

Then I introduce one big change, which is to maximize over all four classes of policies. Perhaps the most important innovation of this book is to break the almost automatic link between optimizing over policies, and then assuming that we are going to compute an optimal policy from either Bellman's equation or the Hamilton-Jacobi equations. These are rarely computable for real problems, which then leads people to assume that the natural next step is to approximate these equations. This is simply false, supported by decades of research where people have developed methods that do not depend on HJB equations. I recognize this body of research developing different classes of policies by

making the inclusion of all four classes of policies fundamental to the original statement of the optimization problem above.

It will take some time for people from the different communities to learn to speak this common language. More likely, there will be an adaptation of existing modeling languages to this framework. For example, the optimal control community could keep their notation, but learn to write their objective functions as I have above, recognizing that the search over policies needs to span all four classes (which, I might point out, they are already using). I would hope that the reinforcement learning community, which adopted the notation for discrete action a, might learn to use the more general x (as the bandit community has already done).

I have tried to write this book to appeal to newcomers to the field, as well as people who already have training in one or more of the subfields that deal with decisions and uncertainty; recognizing these two broad communities was easily the biggest challenge while writing this book. Not surprisingly, the book is quite long. I have tried to make it more accessible to people who are new to the field by marking many sections with an * as an indication that this section can be skipped on a first-read. I also hope that the book will appeal to people from many application domains. However, the core audience is people who are looking to solve real problems by modeling applications and implementing the work in software. The notation is designed to facilitate writing computer programs, where there should be a direct relationship between the mathematical model and the software. This is particularly important when modeling the flow of information, something that is often overlooked in mainstream reinforcement learning papers.

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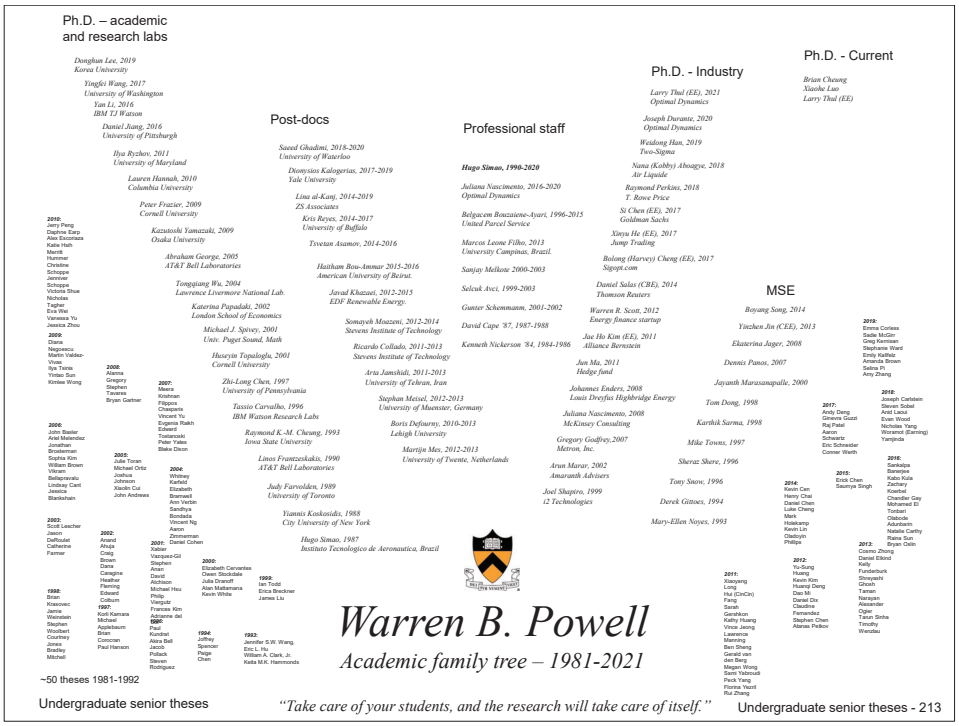
Princeton, New Jersey
August, 2021

ACKNOWLEDGMENTS

The foundation of this book is a modeling framework for sequential decision problems that involves searching over four classes of policies for making decisions. The recognition that we needed all four classes of policies came from working on a wide range of problems spanning freight transportation (almost all modes), energy, health, e-commerce, finance, and even materials science (!!).

This research required a *lot* of computational work, which was only possible through the efforts of the many students and staff that worked in CASTLE Lab. Over my 39 years of teaching at Princeton, I benefited tremendously from the interactions with 70 graduate students and post-doctoral associates, along with nine professional staff. I am deeply indebted to the contributions of this exceptionally talented group of men and women who allowed me to participate in the challenges of getting computational methods to work on such a wide range of problems. It was precisely this diversity of problem settings that led me to appreciate the motivation for the different methods for solving problems. In the process, I met people from across the jungle, and learned to speak their language not just by reading papers, but by talking to them and, often, working on their problems.

I would also like to acknowledge what I learned from supervising over 200 senior theses. While not as advanced as the graduate research, the undergraduates helped expose me to an even wider range of problems, spanning topics such as sports, health, urban transportation, social networks, agriculture, pharmaceuticals, and even optimizing Greek cargo ships. It was the undergraduates who accelerated my move into energy in 2008, allowing me to experiment with modeling and solving a variety of problems spanning microgrids, solar arrays, energy storage, demand management and storm response. This experience exposed me to new challenges, new methods, and most important, new communities in engineering and economics.



The group of students and staff who participated in CASTLE Lab is much too large to list in this acknowledgment, but I have included my academic family tree above. To everyone in this list, my warmest thanks!

I owe a special thanks to the sponsors of CASTLE Lab, which included a number of government funding agencies including the National Science Foundation, the Air Force Office of Scientific Research, DARPA, the Department of Energy (through Columbia University and the University of Delaware), and Lawrence Livermore National Laboratory (my first energy sponsor). I would particularly like to highlight the Optimization and Discrete Mathematics Program of AFOSR that provided me with almost 30 years of unbroken funding. I would like to express my appreciation to the program managers of the ODM program, including Neal Glassman (who gave me my start in this program), Donald Hearn (who introduced me to the materials science program), Fariba Fahroo (whose passion for this work played a major role in its survival at AFOSR), and Warren Adams. Over the years I came to have a deep appreciation for the critical role played by these program managers who provide a critical bridge between academic researchers and the policy makers who have to then sell the work to Congress.

I want to recognize my industrial sponsors and the members of my professional staff that made this work possible. Easily one of the most visible features of CASTLE Lab was that we did not just write academic papers and run computer simulations; our work was implemented in the field. We would work with a company, identify a problem, build a model and then see if it worked, and it often did not. This was true research, with a process that I once documented with a booklet called "From the Laboratory to the Field,

and Back." It was this back and forth process that allowed me to learn how to model and solve real problems. We had some early successes, followed by a period of frustrating failures as we tackled even harder problems, but we had two amazing successes in the early 2000s with our implementation of a locomotive optimization system at Norfolk Southern Railway using approximate dynamic programming, and our strategic fleet simulator for Schneider National (one of the largest truckload carriers in the U.S.). This software was later licensed to Optimal Dynamics which is implementing the technology in the truckload industry. My industrial sponsors received no guarantees when they funded our research, and their (sometimes misplaced) confidence in me played a critical role in our learning process.

Working with industry from a university research lab, especially for a school like Princeton, introduces administrative challenges that few appreciate. Critical to my ability to work with industry was the willingness of a particular grants officer at Princeton, John Ritter, to negotiate contracts where companies funded the research, and were then given royalty-free licenses to use the software. This was key, since it was through their use of the software that I learned what worked, and what did not. John understood that the first priority at a university is supporting the faculty and their research mission rather than maximizing royalties. I think that I can claim that my $50 million in research funding over my career paid off pretty well for Princeton.

Finally, I want to recognize the contributions of my professional staff who made these industrial projects possible. Most important is the very special role played by Hugo Simao, my first Ph.D. student who graduated, taught in Brazil, and returned in 1990 to help start CASTLE Lab. Hugo played so many roles, but most important as the lead developer on a number of major projects that anchored the lab, notably the multidecade relationship with Yellow Freight System/YRC. He was also the lead developer of our award-winning model for Schneider National that was later licensed to Optimal Dynamics, in addition to our big energy model, SMART-ISO, which simulated the PJM power grid. This is not work that can be done by graduate students, and Hugo brought his tremendous skill to the development of complex systems, starting in the 1990s when the tools were relatively primitive. Hugo also played an important role guiding students (graduate and undergraduate) with their software projects, given that I retired from programming in 1990 as the world transitioned from Fortan to C. Hugo brought talent, patience, and an unbelievable work ethic that provided the foundation in funding that made CASTLE Lab possible. Hugo was later joined by Belgacem Bouzaiene-Ayari who worked at the lab for almost 20 years and was the lead developer on another award-winning project with Norfolk Southern Railway, along with many other contributions. I cannot emphasize enough the value of the experience of working with these industrial sponsors, but this is not possible without talented research staff such as Hugo and Belgacem.

W. B. P.

PART I - INTRODUCTION

We have divided the book into 20 chapters organized into six parts. Part I includes four chapters that set the foundation for the rest of the book:

- Chapter 1 provides an introduction to the broad field that we are calling "sequential decision analytics." It introduces our universal modeling framework which reduces sequential decision problems to one of finding methods (rules) for making decisions, which we call *policies.*

- Chapter 2 introduces fifteen major canonical modeling frameworks that have been used by different communities. These communities all approach sequential decision problems under uncertainty from a different perspectives, using eight different modeling systems, typically focusing on a major problem class, and featuring a particular solution method. Our modeling framework will span all of these communities.

- Chapter 3 is an introduction to online learning, where the focus is on sequential vs. batch learning. This can be viewed as an introduction to machine learning, but focusing exclusively on adaptive learning, which is something we are going to be doing throughout the book.

- Chapter 4 sets the stage for the rest of the book by organizing sequential decision problems into three categories: 1) problems that can be solved using deterministic mathematics, 2) problems where randomness can be reasonably approximated using a sample (and then solved using deterministic mathematics), and 3) problems that can only be solved with adaptive learning algorithms, which is the focus of the remainder of the book.

Chapter 1 provides an overview of the universal modeling framework that covers any sequential decision problem. It provides a big picture of our entire framework for modeling and solving sequential decision problems, which should be of value to any reader regardless of their background in decisions under uncertainty. It describes the scope of problems, a brief introduction to modeling sequential decision problems, and sketches the four classes of policies (methods for making decisions) that we use to solve these problems.

Chapter 2 summarizes the canonical modeling frameworks for each of the communities that address some form of sequential decision problem, using the notation of that field. Readers who are entirely new to the field might skim this chapter to get a sense of the variety of approaches that have been taken. Readers with more depth will have some level of expertise in one or more of these canonical problems, and it will help provide a bridge between that problem and our framework.

Chapter 3 covers online learning in some depth. This chapter should be skimmed, and then used as a reference source as needed. A good starting point is to read section 3.1, and then skim the headers of the remaining sections. The book will repeatedly refer back to methods in this chapter.

Finally, chapter 4 organizes stochastic optimization problems into three categories:

1) Stochastic optimization problems that can be solved exactly using deterministic mathematics.

2) Stochastic optimization problems where uncertainty can be represented using a fixed sample. These can still be solved using deterministic mathematics.

3) Stochastic optimization problems that can only be solved using sequential, adaptive learning algorithms. This will be the focus of the rest of the book.

This chapter reminds us that there are special cases of problems that can be solved exactly, possibly by replacing the original expectation with a sampled approximation. The chapter closes by setting up some basic concepts for learning problems, including making the important distinction between online and offline problems, and by identifying different strategies for designing policies for adaptive learning.

CHAPTER 1

SEQUENTIAL DECISION PROBLEMS

A sequential decision problem, simply stated, consists of the sequence

$$decision,\ information,\ decision,\ information,\ decision, \ldots$$

As we make decisions, we incur costs or earn rewards. Our challenge is how to represent the information that will arrive in the future, and how to make decisions, both now and in the future. Modeling these problems, and making effective decisions in the presence of the uncertainty of new information, is the goal of this book.

The first step in sequential decision problems is to understand what decisions are being made. It is surprising how often it is that people faced with complex problems, which spans scientists in a lab to people trying to solve major health problems, are not able to identify the decisions they face.

We then want to find a method for making decisions. There are at least 45 words in the English language that are equivalent to "method for making a decision," but the one we have settled on is *policy*. The term policy is very familiar to fields such as Markov decision processes and reinforcement learning, but with a much narrower interpretation than we will use. Other fields do not use the term at all. Designing effective policies will be the focus of most of this book.

Even more subtle is identifying the different sources of uncertainty. It can be hard enough trying to identify potential decisions, but thinking about all the random events that might affect whatever it is that you are managing, whether it is reducing disease, managing inventories, or making investments, can seem like a hopeless challenge. Not only are there

Reinforcement Learning and Stochastic Optimization. By Warren B. Powell

a wide range of sources of uncertainty, but there is also tremendous variety in how they behave.

Making decisions under uncertainty spans an exceptionally rich set of problems in analytics, arising in fields such as engineering, the sciences, business, economics, finance, psychology, health, transportation, and energy. It encompasses active learning problems, where the decision is to collect information, that arise in the experimental sciences, medical decision making, e-commerce, and sports. It also includes iterative algorithms for stochastic search, which arises in machine learning (finding the model that best fits the data) or finding the best layout for an assembly line using a simulator. It also includes two-agent games and multiagent systems. In fact, we might claim that virtually any human enterprise will include instances of sequential decision problems.

Decision making under uncertainty is a universal experience, something every human has had to manage since our first experiments trying new foods when we were two years old. Some samples of everyday problems where we have to manage uncertainty in our own lives include:

- Personal decisions - These might include how much to withdraw from an ATM machine, finding the best path to a new job, and deciding what time to leave to make an appointment.
- Food shopping - We all have to eat, and we cannot run to the store every day, so we have to make decisions of when to go shopping, and how much to stock up on different items when we do go.
- Health decisions - Examples include designing diet and exercise programs, getting annual checkups, performing mammograms and colonoscopies.
- Investment decisions - Which mutual fund should you use? How should you allocate your investments? How much should you put away for retirement? Should you rent or purchase a house?

Sequential decision problems are ubiquitous, and as a result come in many different styles and flavors. Decisions under uncertainty span virtually every major field. Table 1.1 provides a list of problem domains and a sample of questions that can arise in each of these fields. Not surprisingly, a number of different analytical fields have emerged to solve these problems, often using different notational systems, and presenting solution approaches that are suited to the characteristics of the problems in each setting.

This book will provide the analytical foundation for sequential decision problems using a "model first, then solve" philosophy. While this is standard in fields such as deterministic optimization and machine learning, it is not at all standard in the arena of making decisions under uncertainty. The communities that work on sequential decision problems tend to come up with a method for solving a problem, and then look for applications. This can come across as if we have a hammer looking for a nail.

The limitation of this approach is that the different methods that have been developed can only serve a subset of problems. Consider one of the simplest and most classical sequential decision problems: managing an inventory of product to serve demands over time. Let R_t be our inventory at time t, x_t is how much we order (that arrives instantly), to serve a demand $\hat{D}_{t+1}$ that is not known at time t. The evolution of the inventory R_t is given by

$$R_{t+1} = \max\{0, R_t + x_t - \hat{D}_{t+1}\}. \tag{1.1}$$

Field	Questions
Business	What products should we sell, with what features? Which supplies should you use? What price should you charge? How should we manage our fleet of delivery vehicles? Which menu attracts the most customers?
Economics	What interest rate should the Federal Reserve charge given the state of the economy? What levels of market liquidity should be provided? What guidelines should be imposed on investment banks?
Finance	What stocks should a portfolio invest in? How should a trader hedge a contract for potential downside? When should we buy or sell an asset?
Internet	What ads should we display to maximize ad-clicks? Which movies attract the most attention? When/how should mass notices be sent?
Engineering	How to design devices from aerosol cans to electric vehicles, bridges to transportation systems, transistors to computers?
Materials science	What combination of temperatures, pressures and concentrations should we use to create a material with the highest strength?
Public health	How should we run testing to estimate the progression of a disease? How should vaccines be allocated? Which population groups should be targeted?
Medical research	What molecular configuration will produce the drug which kills the most cancer cells? What set of steps are required to produce single-walled nanotubes?
Supply chain management	When should we place an order for inventory from China? What mode of transportation should be used? Which supplier should be used?
Freight transportation	Which driver should move a load? What loads should a truckload carrier commit to move? Where should drivers be domiciled?
Information collection	Where should we send a drone to collect information on wildfires or invasive species? What drug should we test to combat a disease?
Multiagent systems	How should a large company in an oligopolistic market bid on contracts, anticipating the response of its competitors? How should a submarine behave given the presence of adversarial submarines?
Algorithms	What stepsize rule should we use in a search algorithm? How do we determine the next point to evaluate an expensive function?

Table 1.1 A list of application domains and decisions that need to be made.

For this problem, we might use the following policy: when the inventory falls below a value θ^{min}, order enough to bring it up to θ^{max}. All we have to do is to determine the parameter vector $\theta = (\theta^{min}, \theta^{max})$. The policy is quite simple, but finding the best value of θ can be quite challenging.

Now consider a series of inventory problems with increasing complexity, illustrated by the setting in figure 1.1 of a warehouse in the southeastern United States ordering inventory:

1) The inventory we order comes from China, and might take 90 to 150 days to arrive.

2) We have to serve demand that varies seasonally (and dramatically changes around the Christmas holiday season).

3) We are given the option to use air freight for a particular order that reduces the time by 30 days.

Figure 1.1 Illustration of shipments coming from China to the U.S. with a threat of a storm.

4) We are selling expensive gowns, and we have to pay special attention to the risk of a stockout if there is a delay in either the production (which we can handle by using air freight) or a delay in offloading at the port.

5) The gowns come in different styles and colors. If we run short of one color, the customer might be willing to accept a different color.

6) We are allowed to adjust the price of the item, but we do not know precisely how the market will respond. As we adjust the price and observe the market response, we learn from this observation and use what we learn to guide future pricing decisions.

Each of these modifications would affect our decision, which means a modification of the original policy in some way.

The simple inventory problem in equation (1.1) has just a single decision, x_t, specifying how much inventory to order now. In a real problem, there is a spectrum of downstream decisions that might be considered, including

- How much to order, and the choice of delivery commitment that determines how quickly the order arrives: rush orders, normal, relaxed.
- Pricing of current inventory while waiting for the new inventory to arrive.
- Reservations for space on cargo ships in the future.
- The speed of the cargo ship.
- Whether to rush additional inventory via air freight to fill a gap due to a delay.
- Whether to use truck or rail to move the cargo in from the port.

Then, we have to think about the different forms of uncertainty for a product that might take at least 90 days to arrive:

- The time to complete manufacturing.
- Weather delays affecting ship speeds.
- Land transportation delays.

- Product quality on arrival.
- Currency changes.
- Demand for inventory on hand between now and the arrival of new inventory.

If you set up a toy problem such as equation (1.1), you would never think about all of these different decisions and sources of uncertainty. Our presentation will feature a rich modeling framework that emphasizes our philosophy:

Model first, then solve.

We will introduce, for the first time in a textbook, a universal modeling framework for *any* sequential decision problem. We will introduce four broad classes of methods, known as policies, for making decisions that span *any* method that might be used, including anything in the academic literature or used in practice. Our goal is not to always choose the policy that performs the best, since there are multiple dimensions to evaluating a policy (computational complexity, transparency, flexibility, data requirements). However, we will always choose our policy with one eye to performance, which means the statement of an objective function will be standard. This is not the case in all communities that work on sequential decision problems.

1.1 THE AUDIENCE

This book is aimed at readers who want to develop models that are practical, flexible, scalable, and implementable for sequential decision problems in the presence of different forms of uncertainty. The ultimate goal is to create software tools that can solve real problems. We use careful mathematical modeling as a necessary step for translating real problems into software. The readers who appreciate both of these goals will enjoy our presentation the most.

Given this, we have found that this material is accessible to professionals from a wide range of fields, spanning application domains (engineering, economics, and the sciences) to those with more of a methodological focus (such as machine learning, computer science, optimal control, and operations research) with a comfort level in probability and statistics, linear algebra, and, of course, computer programming.

Our presentation emphasizes modeling and computation, with minimal deviations into theory. The vast majority of the book can be read with a good course in probability and statistics, and a basic knowledge of linear algebra. Occasionally we will veer into higher dimensional applications such as resource allocation problems (e.g. managing inventories of different blood types, or trading portfolios of assets) where some familiarity with linear, integer and/or nonlinear programming will be useful. However, these problems can all be solved using powerful solvers with limited knowledge of how these algorithms actually work.

This said, there is no shortage of algorithmic challenges and theoretical questions for the advanced Ph.D. student with a strong background in mathematics.

1.2 THE COMMUNITIES OF SEQUENTIAL DECISION PROBLEMS

Figure 1.2 shows some prominent books from various methodological communities in the sequential decision-making field. These communities, which are discussed in greater depth

Figure 1.2 A sampling of major books representing different fields in stochastic optimization.

in chapter 2, are listed in table 1.2 in the approximate order in which the field emerged. We note that there are two distinct fields that are known as derivative-based stochastic search, and derivative-free stochastic search, that both trace their roots to separate papers published in 1951.

Each of these communities deals with some flavor of sequential decision problems, using roughly eight notational systems, and an overlapping set of algorithmic strategies. Each field is characterized by at least one book (often several), and thousands of papers (in some cases, thousands of papers each year). Each community tends to have problems that best fit the tools developed by that community, but the problem classes (and tools) are continually evolving.

The fragmentation of the communities (and their differing notational systems) disguises common approaches developed in different areas of practice, and challenges cross-fertilization of ideas. A problem that starts off simple (like the inventory problem in (1.1)) lends itself to a particular solution strategy, such as dynamic programming. As the problem grows in realism (and complexity), the original technique will no longer work, and we need to look to other communities to find a suitable method.

1) Derivative-based stochastic search	9) Stochastic programming
2) Derivative-free stochastic search	10) Multiarmed bandit problem
3) Decision trees	11) Simulation optimization
4) Markov decision processes	12) Active learning
5) Optimal control	13) Chance constrained programming
6) Approximate dynamic programming	14) Model predictive control
7) Reinforcement learning	15) Robust optimization
8) Optimal stopping	

Table 1.2 Fields that deal with sequential decisions under uncertainty.

We organize all of these fields under the title of "reinforcement learning and stochastic optimization." "Stochastic optimization" refers generally to the analytical fields that address decisions under uncertainty. The inclusion of "reinforcement learning" in the title reflects the growing popularity of this community, and the use of the term to apply to a steadily expanding set of methods for solving sequential decision problems. The goal of this book is to provide a unified framework that covers *all* of the communities that work on these problems, rather than to favor any particular method. We refer to this broader field as *sequential decision analytics*.

Sequential decision analytics requires integrating tools and concepts from three core communities from the mathematical sciences:

Statistical machine learning - Here we bring together the fields of statistics, machine learning and data sciences. Most (although not all) of our applications of these tools will involve recursive learning. We will also draw on the fields of both frequentist and Bayesian statistics, but all of this material is provided here.

Mathematical programming - This field covers the core methodologies in derivative-based and derivative-free search algorithms, which we use for purposes ranging from computing policies to optimizing the parameters of a policy. Occasionally we will encounter vector-valued decision problems that require drawing on tools from linear, integer and possibly nonlinear programming. Again, all of these methods are introduced and presented without assuming any background in stochastic optimization.

Stochastic modeling and simulation - Optimizing a problem in the presence of uncertainty often requires a careful model of the uncertain quantities that affect the performance of a process. We include a basic introduction to Monte Carlo simulation methods, but expect a background in probability and statistics, including the use of Bayes theorem.

While our presentation does not require advanced mathematics or deep preparation in any methodological area, we will be blending concepts and methods from all three of these fields. Dealing with uncertainty is inherently more subtle than deterministic problems, and requires more sophisticated modeling than arises in machine learning.

1.3 OUR UNIVERSAL MODELING FRAMEWORK

Central to the entire book is the use of a single modeling framework, as is done in deterministic optimization and machine learning. Ours is based heavily on the one widely used in optimal control. This has proven to be the most practical and flexible, and offers a clear relationship between the mathematical model and its implementation in software. While much of our presentation will focus on modeling sequential decision problems and developing practical methods for making decisions, we also recognize the importance of developing models of the different sources of uncertainty (a topic that needs a book of its own).

Although we revisit this in more detail in chapter 9, it helps to sketch our universal modeling framework. The core elements are:

- State variables S_t - The state variable contains everything we know, and only what we need to know, to make a decision and model our problem. State variables include physical state variables R_t (the location of a drone, inventories, investments

in stocks), other information I_t about parameters and quantities we know perfectly (such as current prices and weather), and beliefs B_t, in the form of probability distributions, describing parameters and quantities that we do not know perfectly (this could be an estimate of how much a drug will lower the blood sugar in a new patient, or how the market will respond to price).

- Decision variables x_t - A decision variable can be binary (hold or sell), a discrete set (drugs, products, paths), a continuous variable (such as a price or dosage), and vectors of discrete and continuous variables. Decisions are subject to constraints $x_t \in \mathcal{X}_t$, and we make decisions using a method we call a policy $X^\pi(S_t)$. We introduce the notation for a policy, but we defer the design of the policy until after we complete the model. This is the basis of what we call *model first, then solve*.

- Exogenous information W_{t+1} - This is the information that we learn after we make a decision (market response to a price, patient response to a drug, the time to traverse a path), that we did not know when we made the decision. Exogenous information comes from outside whatever system we are modeling. (Decisions, on the other hand, can be thought of as an *endogenous information process* since we make decisions, a form of information, internally to the process.)

- The transition function $S^M(S_t, x_t, W_{t+1})$ which consists of the equations required to update *each* element of the state variable. This covers all the dynamics of our system, including the updating of estimates and beliefs for sequential learning problems. Transition functions are widely used in control theory using the notation $f(x, u, w)$ (for state x, control u and information w); our notation, which stands for the "state transition model" or "system model" helps us avoid using the popular letter $f(\cdot)$.

- The objective function - This first consists of the contribution (or reward, or cost, ...) we make each time period, given by $C(S_t, x_t)$, where $x_t = X^\pi(S_t)$ is determined by our policy, and S_t is our current state, which is computed by the transition function. As we are going to demonstrate later in the book, there are different ways to write the objective function, but our most common will be to maximize the cumulative contributions, which we write as

$$\max_\pi \mathbb{E}\left\{\sum_{t=0}^{T} C(S_t, X^\pi(S_t))|S_0\right\}. \tag{1.2}$$

  where the expectation $\mathbb{E}$ means "take an average over all types of uncertainty" which might be uncertainty about how a drug will perform, or how the market will respond to price (captured in the initial state S_0), as well as the uncertainty in the information $W_1, \ldots, W_t, \ldots$ that arrives over time. The maximization over policies simply means that we want to find the best method for making decisions. Most of this book is dedicated to the challenge of searching over policies.

Once we have identified these five elements, we still have two remaining steps to complete before we are done.

- Stochastic modeling (also known as uncertainty quantification) - There can be uncertainty about parameters and quantities in the state variable (including the initial state S_0), as well as our exogenous information process $W_1, W_2, \ldots, W_t, \ldots$. In some instances, we may avoid modeling the W_t process by observing a physical system.

Otherwise, we need a mathematical model of the possible realizations of W_{t+1} given S_t and our decision x_t (either of which can influence W_{t+1}).

- Designing policies - Only after we are done with modeling do we turn to the problem of designing the policy $X^\pi(S_t)$. This is the point of departure between this book and all the books in our jungle of stochastic optimization. We do not pick policies before we develop our model; instead, once the modeling is done, we will provide a roadmap to every possible policy, with guidelines of how to choose among them.

  The policy π consists of some type of function $f \in \mathcal{F}$, possibly with tunable parameters $\theta \in \Theta^f$ that are associated with the function f, where the policy maps the state to a decision. The policy will often contain an imbedded optimization problem within the function. This means that we could write (1.2) as

$$\max_{\pi=(f\in\mathcal{F},\theta\in\Theta^f)} \mathbb{E}\left\{\sum_{t=0}^{T} C(S_t, X^\pi(S_t))|S_0\right\}. \tag{1.3}$$

  This leaves the question: How do we search over functions? Most of this book is dedicated to describing precisely how to do this.

Using this notation, we can revise our original characterization of a sequential decision problem, which we earlier described as *decision, information, decision, information, ...* as the sequence

$$(S_0, x_0, W_1, S_1, x_1, W_2, \ldots, S_t, x_t, W_{t+1}, \ldots, S_T),$$

where we now write the triplet "state, decision, new information" to capture what we know (the state variable S_t), which we use to make a decision x_t, followed by what we learn after we make a decision, the exogenous information W_{t+1}. We earn a contribution $C(S_t, x_t)$ from our decision x_t (we could say we earn a reward or incur a cost), where the decision comes from a policy $X^\pi(S_t)$.

There are many problems where it is more natural to use a counter n (the n^{th} experiment, the n^{th} customer arrival), in which case we would write our sequential decision problem as

$$(S^0, x^0, W^1, S^1, x^1, W^2, \ldots, S^n, x^n, W^{n+1}, \ldots, S^N).$$

There are even settings where we use both, as in $(S^n_t, x^n_t, W^n_{t+1})$ to capture, for example, decisions in the n^{th} week at hour t.

We note in passing that there are problems that consist of "decision, information, stop," "decision, information, decision, stop," "information, decision, information, decision, ...," and problems where the sequencing proceeds over an infinite horizon. We use a finite sequence as our default model.

We can illustrate our modeling framework using our simple inventory problem that we started with above.

- State variables S_t - For the simplest problem this is the inventory R_t.
- Decision variables x_t - This is how much we order at time t, and for now, we assume it arrives right away. We also introduce our policy $X^\pi(S_t)$, where $x_t = X^\pi(S_t)$, which we will design after we create our model.
- Exogenous information W_{t+1} - This would be the demand $\hat{D}_{t+1}$ that arises between t and $t+1$.

- The transition function $S^M(S_t, x_t, W_{t+1})$ - This would be the evolution of our inventory R_t, given by

$$R_{t+1} = \max\{0, R_t + x_t - \hat{D}_{t+1}\}. \tag{1.4}$$

- The objective function - This is an example of a problem where it is more natural to write the single-period contribution function *after* we observe the information W_{t+1} since this contains the demand $\hat{D}_{t+1}$ that we will serve with the inventory x_t we order in period t. For this reason, we might write our contribution function as

$$C(S_t, x_t, W_{t+1}) = p \min\{R_t + x_t, \hat{D}_{t+1}\} - cx_t.$$

  where p is the price at which we sell our product, and c is the cost per unit of product. Our objective function would be given by

$$\max_{\pi} \mathbb{E}\left\{\sum_{t=0}^{T} C(S_t, X^{\pi}(S_t), W_{t+1})|S_0\right\},$$

  where $x_t = X^{\pi}(S_t)$, and we have to be given a model of the exogenous information process $W_1, \ldots, W_T$. Since the exogenous information is random, we have to take the expectation $\mathbb{E}$ of the sum of contributions to average over all the possible outcomes of the information process.

Our next step would be to develop a mathematical model of the distribution of demand $\hat{D}_1, \hat{D}_2, \ldots, \hat{D}_t, \ldots$ which draws on tools that we introduce in chapter 10.

To design our policy $X^{\pi}(S_t)$, we might turn to the academic literature that shows, for this simple problem, that the policy has an order-up-to structure given by

$$X^{Inv}(S_t|\theta) = \begin{cases} \theta^{max} - R_t & \text{if } R_t < \theta^{min}, \\ 0 & \text{otherwise.} \end{cases} \tag{1.5}$$

This is a parameterized policy, which leaves us the challenge of finding $\theta = (\theta^{min}, \theta^{max})$ by solving

$$\max_{\theta} \mathbb{E}\left\{\sum_{t=0}^{T} C(S_t, X^{Inv}(S_t|\theta), W_{t+1})|S_0\right\}. \tag{1.6}$$

Here we chose a particular class of policy, and then optimized within the class.

We pause to note that using our modeling approach creates a direct relationship between our mathematical model and computer software. Each of the variables above can be translated directly to a variable name in a computer program, with the only exception that the expectation operator has to be replaced with an estimate based on simulation (we show how to do this). This relationship between mathematical model and computer software does not exist with most of the current modeling frameworks used for decisions under uncertainty, with one major exception - optimal control.

Earlier in the chapter we proposed a number of generalizations to this simple inventory problem. As we progress through the book, we will show that our five-step universal modeling framework holds up for modeling much more complex problems. In addition, we will introduce four classes of policies that will span any method that we might want to consider to solve more complex versions of our problem. In other words, not only will our modeling framework be able to model any sequential decision problem, we will outline four classes of policies that are also universal: they encompass any method that has been studied in the research literature or used in practice. The next section provides an overview of these four classes of policies.

1.4 DESIGNING POLICIES FOR SEQUENTIAL DECISION PROBLEMS

What often separates one field of stochastic optimization from another is the type of policy that is used to solve a problem. Possibly the most important aspect of our unified framework in this book is how we have identified and organized different classes of policies. These are first introduced in chapter 7 in the context of derivative-free stochastic optimization (a form of pure learning problem), and then in greater depth in chapter 11 on designing policies, which sets the stage for the entire remainder of the book. In this section we are going to provide a peek at our approach for designing policies.

The entire literature on making decisions under uncertainty can be organized along two broad strategies for creating policies:

Policy search - This includes all policies where we need to search over:

- Different classes of functions $f \in \mathcal{F}$ for making decisions. For example, the order-up-to policy in equation (1.5) is a form of nonlinear parametric function.
- Any tunable parameters $\theta \in \Theta^f$ that are introduced by function f. $\theta = (\theta^{min}, \theta^{max})$ in equation (1.5) is an example.

If we select a policy that contains parameters, then we have to find the set of parameters θ to maximize (or minimize) an objective function such as (1.6).

Lookahead approximations - These are policies formed so we make the best decision now given an approximation of the downstream impact of the decision. These are the policy classes that have attracted the most attention from the research community.

Our order-up-to policy $X^{Inv}(S_t|\theta)$ is a nice example of a policy that has to be optimized (we might say tuned). The optimization can be done using a simulator, as is implied in equation (1.6), or in the field.

Each of these two strategies produce policies that can be divided into two classes, creating four classes of policies. We describe these below.

1.4.1 Policy search

Policies in the policy search class can be divided into two subclasses:

1) Policy function approximations (PFAs) - These are analytical functions that map a state (which includes all the information available to us) to a decision (the order-up-to policy in equation (1.5) is a PFA). These are discussed in greater depth in chapter 12.

2) Cost function approximations (CFAs) - CFA policies are parameterized optimization models (typically deterministic optimization models) that have been modified to help them respond better over time, and under uncertainty. CFAs have an imbedded optimization problem *within the policy*. The concept of CFAs are presented in this book for the first time as a major new class of policies. CFAs are introduced and illustrated in chapter 13.

PFAs are any analytical function that maps what we know in the state variable to a decision. These analytical functions come in three flavors:

Lookup tables - These are used when a discrete state S can be mapped to a discrete action, such as:

- If the patient is male, over 60 with high blood sugar, then prescribe metformin.
- If your car is at a particular intersection, turn left.

Parametric functions - These describe any analytical functions parameterized by a vector of parameters θ. Our order-up-to policy is a simple example. We might also write it as a linear model such as

$$X^{PFA}(S_t|\theta) = \theta_1\phi_1(S_t) + \theta_2\phi_2(S_t) + \theta_3\phi_3(S_t) + \theta_4\phi_4(S_t).$$

where $\phi_f(S_t)$ are features extracted from information in the state variable. Neural networks are another option.

Nonparametric functions - These include functions that might be locally linear approximations, or deep neural networks.

The second class of functions that can be optimized using policy search is called parametric *cost function approximations*, or CFAs, which are parameterized optimization problems. A simple CFA used in learning problems is called interval estimation and might be used to determine which ad gets the most clicks on a website. Let $\mathcal{X} = \{x_1, \ldots, x_M\}$ be the set of ads (there may be thousands of them), and let $\bar{\mu}_x^n$ be our current best estimate of the probability that ad x will be clicked on after we have run n observations (across all ads). Then let $\bar{\sigma}_x^n$ be the standard deviation of the estimate $\bar{\mu}_x^n$. Interval estimation would choose as the next ad

$$X^{CFA}(S^n|\theta) = \arg\max_{x\in\mathcal{X}} \left(\bar{\mu}_x^n + \theta\bar{\sigma}_x^n\right), \tag{1.7}$$

where "$\arg\max_x$" means to find the value of x that maximizes the expression in parentheses. The distinguishing features of a CFA is that it requires solving an imbedded optimization problem (the max over ads), and there is a tunable parameter θ.

Once we introduce the idea of solving an optimization problem within the policy (as we did with the policy in (1.7)), we can solve *any* parameterized optimization problem. We are no longer restricted to the idea that x has to be one of a set of discrete choices; it can be a large integer program, such as those used to plan airline schedules with schedule slack inserted to handle possible weather delays, or planning energy generation for tomorrow with reserves in case a generator fails (both of these are real instances of CFAs used in practice).

1.4.2 Policies based on lookahead approximations

A natural strategy for making decisions is to consider the downstream impact of a decision you make now. There are two ways of doing this:

3) Value function approximations (VFAs) - One popular approach for solving sequential decision problems applies the principles of a field known as *dynamic programming* (or Markov decision processes). Imagine our state variable tells us where we are on a network where we have to make a decision, or the amount of inventory we are holding. Assume that someone tells us that if we are in state S_{t+1} at time $t+1$ (that is, we are at some node in the network or will have some level of inventory), that $V_{t+1}(S_{t+1})$ is the "value" of being in state S_{t+1}, which we can think of as the cost of the shortest path to the destination, or our expected profits from time $t+1$ onward if we start with inventory S_{t+1}.

Now assume we are in a state S_t at time t and trying to determine which decision x_t we should make. After we make the decision x_t, we observe the random variable(s) W_{t+1} that take us to $S_{t+1} = S^M(S_t, x_t, W_{t+1})$ (for example, our inventory equation (1.4) in our example above). Assuming we know $V_{t+1}(S_{t+1})$, we can find the value of being in state S_t by solving

$$V_t(S_t) = \max_{x_t} \big(C(S_t, x_t) + \mathbb{E}_{W_{t+1}}\{V_{t+1}(S_{t+1})|S_t\}\big), \tag{1.8}$$

where it is best to think of the expectation operator $\mathbb{E}_{W_{t+1}}$ as averaging over all outcomes of W_{t+1}. The value of x_t^* that optimizes equation (1.8) is then the optimal decision for state S_t. The first period contribution $C(S_t, x_t^*)$ plus the future contributions $\mathbb{E}_{W_{t+1}}\{V_{t+1}(S_{t+1})|S_t\}$ gives us the value $V_t(S_t)$ of being in state S_t now. When we know the values $V_t(S_t)$ for all time periods, and all states, we have a VFA-based policy given by

$$X_t^{VFA}(S_t) = \arg\max_{x_t} \big(C(S_t, x_t) + \mathbb{E}_{W_{t+1}}\{V_{t+1}(S_{t+1})|S_t\}\big), \tag{1.9}$$

where "$\arg\max_{x_t}$" returns the value x_t that maximizes (1.9).

Equation (1.9) is a powerful way of computing optimal policies, but it is rarely computable in practical problems (chapter 14 presents some problem classes that can be solved exactly). For this reason, a number of communities have developed ways of approximating the value function under names such as approximate dynamic programming, adaptive dynamic programming or, most visibly, reinforcement learning. These fields replace the exact value function $V_{t+1}(S_{t+1})$ with an approximation $\overline{V}_{t+1}(S_{t+1})$ estimated using machine learning.

VFA-based policies have attracted considerable attention from the research literature, and are possibly the most difficult of the four classes of policies. We cover approximations over four chapters (chapters 15 - 18).

4) Direct lookahead approximations (DLAs) - The easiest example of a lookahead policy is a navigation system which plans a path to your destination, and then tells you which turn to take next. As new information arrives, the path is updated.

This is an example of a deterministic lookahead for a stochastic problem. While deterministic lookaheads are useful in some applications, there are many where we have to explicitly consider uncertainty as we make a decision, which means we have to solve a stochastic optimization problem within our direct lookahead policy! There are entire fields of research focused on specific methods for solving direct lookahead models under uncertainty. We present a general framework for modeling and solving direct lookahead policies in chapter 19.

1.4.3 Mixing and matching

It is possible to create hybrid policies by blending strategies from multiple classes. We can create a lookahead policy H periods into the future, and then use a value function approximation to approximate the states at the end of the planning horizon. We can use a deterministic lookahead, but introduce tunable parameters to make it work better under uncertainty. We can combine a PFA (think of this as some analytical function that suggests a decision), and weight any deviation of the decision from the PFA and add it to any other

optimization-based policy. When we get to stochastic lookaheads in chapter 19, we may end up using all four classes at the same time.

An example of a hybrid policy is determining both the path to drive to a destination, and the time of departure. Navigation systems use a deterministic lookahead, solving a shortest path problem using point estimates of the travel times on each link of a network. This path might produce an estimated travel time of 40 minutes, but when do you actually leave? Now you are aware of the uncertainty of traffic, so you might decide to add in a buffer. As you repeat the trip, you may adjust the buffer up or down as you evaluate the accuracy of the estimate. This is a combined direct lookahead (since it plans a path into the future) with a tunable parameter for the departure time (making it a form of PFA).

As we said, we cannot tell you how to solve any particular problem (the diversity is simply too great), but we will give you a complete toolbox, with some guidelines to help in your choice.

1.4.4 Optimality of the four classes

There is a widespread misconception in the academic research literature that equation (1.8) (known either as Bellman's equation, or the Hamilton-Jacobi equation) is the basis for creating optimal policies, and that any path to designing good (that is, near optimal) policies have to start with Bellman's equation. This is simply not true.

Any of the four classes of policies can contain the optimal policy for specific problem classes. The problem that arises is purely computational. For example, for the vast majority of real applications, Bellman's equation (1.8) is simply not computable. Trying to replace the true value function $V_{t+1}(S_{t+1})$ in equation (1.8) with some approximation $\overline{V}_{t+1}(S_{t+1})$ may work quite well, but there are many settings where it is just not going to produce effective policies. In addition, once you start talking about using approximations of the value function, you open yourself up to the possibility that any of the other three classes of policies may work just as well or (often) better. This is the reason that there are so many people making decisions over time, in the presence of new information, and who do not use (and have not even heard of) Bellman's equation.

1.4.5 Pulling it all together

We claim that the four classes of policies (PFAs, CFAs, VFAs and DLAs) are universal, and cover every method that has been proposed by any of the communities listed earlier, as well as anything used in practice.

Of the four classes, the academic community has focused primarily on VFAs and various forms of DLAs (both deterministic and stochastic). By contrast, our belief is that PFAs and CFAs are much more widely used in practice. CFAs in particular have been largely overlooked in the academic community, but are widely used in practice in an ad hoc way (they are typically not tuned). PFAs and CFAs (that is, the policy search classes) are preferred in practice because they are simpler, but as we will see over and over again:

The price of simplicity is tunable parameters, and tuning is hard!

1.5 LEARNING

A significant part of decision analytics involves learning. Traditional machine learning involves being given a dataset consisting of inputs x^n and the associated response y^n, and then finding a function $f(x|\theta)$ which might be a linear model such as

$$f(x|\theta) = \theta_0 + \theta_1\phi_f(x) + \theta_2\phi_f(x) + \ldots + \theta_F\phi_F(x)$$

where the functions $\phi_f(x)$ extract features from the data in x. The inputs x might be the words in a document, a patient history, weather data, or customer data such as personal data and recent buying history. We might also look at nonlinear models, hierarchical models, and even a neural network. We then have to fit the model by solving the optimization problem

$$\min_\theta \frac{1}{N}\sum_{n=1}^{N}(y^n - f(x^n|\theta))^2.$$

This is classical batch learning.

When we are making decisions sequentially, we also learn sequentially. We might have a patient arrive with medical history h^n; we then decide on treatment $x^{treat,n}$ using a policy $X^\pi(S^n)$ (where S^n includes the patient history h^n). After choosing the treatment, we wait to observe the response, which we would index by y^{n+1} for the same reason that after making decision x^n we observe W^{n+1}. The index "$n+1$" indicates that this is new information not contained in any variable indexed by n.

Our belief state B^n (within the state variable S^n) contains all the information we need to update our estimate θ^n using the new observation y^{n+1}. All of this updating is buried in the transition

$$S^{n+1} = S^M(S^n, x^n, W^{n+1}),$$

just as y^{n+1} is contained within W^{n+1}. The methods for doing this adaptive updating are all covered in chapter 3 on online learning, which is the term the machine learning community uses for learning in a sequential, versus batch, setting.

There are a number of opportunities for using online learning in sequential decision analytics:

1) Approximating the expectation of a function $\mathbb{E}F(x, W)$ to be maximized.

2) Creating an approximate policy $X^\pi(S|\theta)$.

3) Approximating the value of being in a state S_t which we typically represent by $\overline{V}_t(S_t)$.

4) Learning any of the underlying models in a dynamic system. These include:

   4a) The *transition function* $S^M(S_t, x_t, W_{t+1})$ which might describe how a future activity depends on the past.

   4b) The cost or contribution functions which might be unknown if we are trying to replicate human behavior.

5) Parametric cost function approximations, where we use learning to modify the objective function and/or constraints imbedded in the policy.

The tools for estimating these functions are covered in chapter 3, but we visit the specific settings of these different problems throughout the rest of the book.

1.6 THEMES

Our presentation features a series of themes that run through the book. This section reviews some of these.

1.6.1 Blending learning and optimization

Our applications will typically involve some mixture of decisions that influence learning (directly or indirectly) and decisions (perhaps the same decisions) that influence what we learn. It helps to think of three broad classes of problems:

- Pure learning problems - In this problem class decisions only control the information that we acquire for learning. This might arise in laboratory experimentation, computer simulations, and even market tests.
- State-dependent problems without learning - We will occasionally encounter problems where decisions impact a physical system, but where there is no learning. Using a navigation system to tell us which way to turn might be an example where the decisions affect the physical system (planning the path of our car) but where there is no learning.
- Hybrid problems - We will see many settings where a decision both changes the physical system as well as influences information we acquire for learning. There will also be systems with multiple decisions, such as physical decisions for allocating vaccines and testing decisions that guide information collection about the spread of disease or the efficacy of a drug.

1.6.2 Bridging machine learning to sequential decisions

Finding the best policy is the same as finding the best function that achieves the lowest cost, highest profits or best performance. Analogs to this stochastic optimization problem appear in statistics and machine learning, where a common problem is to use a dataset (x^n, y^n), where $x^n = (x_1^n, \ldots, x_K^n)$ is used to predict y^n. For example, we might specify a linear function of the form:

$$y^n = f(x^n|\theta) = \theta_0 + \theta_1 x_1^n + \ldots + \theta_K^n x_K^n + \epsilon^n, \tag{1.10}$$

where ϵ^n is a random error term that is often assumed to be normally distributed with mean 0 and some variance σ^2.

We can find the parameter vector $\theta = (\theta_1, \ldots, \theta_K)$ by solving

$$\min_{\theta} \frac{1}{N} \sum_{n=1}^{N} \big(y^n - f(x^n|\theta)\big)^2. \tag{1.11}$$

Our problem of fitting a model to the data, then, involves two steps. The first is to choose the function $f(x|\theta)$, which we have done by specifying the linear model in equation (1.10) (note that this model is called "linear" because it is linear in θ). The second step involves solving the optimization problem given in (1.11). The only difference is the specific choice of performance metric.

Now consider how we approach sequential decision problems. Assume we are minimizing costs $C(S^n, x^n)$ that depend on our decision x^n as well as other information that

	Statistical learning	Stochastic optimization
(1)	Batch estimation: $\min_\theta \frac{1}{N}\sum_{n=1}^{N}(y^n - f(x^n\|\theta))^2$	Sample average approximation: $\min_{x\in\mathcal{X}} \frac{1}{N}\sum_{n=1}^{N} F(x, W(\omega^n))$
(2)	Online learning: $\min_\theta \mathbb{E}F(Y - f(X\|\theta))^2$	Stochastic search: $\min_\theta \mathbb{E}F(X, W)$
(3)	Searching over functions: $\min_{f\in\mathcal{F},\theta\in\Theta^f} \mathbb{E}F(Y - f(X\|\theta))^2$	Policy search: $\min_\pi \mathbb{E}\sum_{t=0}^{T} C(S_t, X^\pi(S_t))$

Table 1.3 Comparison of classical problems faced in statistics (left) versus similar problems in stochastic optimization (right).

we carry in the state variable S^n. Decisions are made with a policy $x^n = X^\pi(S^n|\theta)$ parameterized by θ which is analogous to the statistical model $f(x^n|\theta)$ that is used to predict (or estimate) y^{n+1} before it becomes known. Our objective function would then be

$$\min_\theta \mathbb{E}\sum_{n=0}^{N-1} C(S^n, X^\pi(S^n|\theta)). \tag{1.12}$$

where $S^{n+1} = S^M(S^n, X^\pi(S^n), W^{n+1})$, and where we are given a source of the sequence $(S^0, W^1, \ldots, W^N)$.

When we compare (1.11) to (1.12), we see that both are searching over a set of functions to minimize some metric. In statistical modeling, the metric requires a dataset $(x^n, y^n)_{n=1}^N$, while our decision problem just requires a contribution (or cost) function $C(S, x)$, along with the transition function $S^{n+1} = S^M(S^n, x^n, W^{n+1})$ and a source of the exogenous information process $W^1, \ldots, W^N$. The tools for searching for θ to solve (1.11) or (1.12) are the same, but the input requirements (a training dataset, or a model of the physical problem) are quite different.

Our statistical model may take any of a wide range of forms, but they are all in the broad class of analytical models that might be a lookup table, parametric or nonparametric model. All of these classes of functions fall in just one of our four classes of policies that we refer to as policy function approximations.

Table 1.3 provides a quick comparison of some major problem classes in statistical learning, and corresponding problems in stochastic optimization. The first row compares the standard batch machine learning problem to our canonical stochastic optimization problem (for a state-independent problem). The second row compares online learning (where we have to adapt to data as it arrives) to online decision making. We use expectations in both cases since the goal is to make decisions now that work well in expectation after the next observation. Finally, the third row is making clear that we are searching for functions in both machine learning and stochastic optimization, where we use the canonical expectation-based form of the objective function. As of this writing, we feel that the research community has only begun to exploit these links, so we ask the reader to be on the lookout for opportunities to help build this bridge.

1.6.3 From deterministic to stochastic optimization

Our approach shows how to generalize a deterministic problem to a stochastic one. Imagine we are solving the inventory problem above, although we are going to start with a deterministic model, and we are going to use standard matrix-vector math to keep the notation as compact as possible. Since the problem is deterministic, we need to make decisions $x_0, x_1, \ldots, x_t, \ldots$ over time (x_t may be a scalar or vector). Let $C_t(x_t)$ be our contribution in period t, given by

$$C_t(x_t) = p_t x_t$$

where p_t is a (known) price at time t. We also require that the decisions x_t satisfy a set of constraints that we write generally as:

$$\begin{aligned} A_t x_t &= R_t, && (1.13)\\ x_t &\geq 0, && (1.14)\\ R_{t+1} &= B_t x_t + \hat{R}_{t+1}. && (1.15) \end{aligned}$$

We wish to solve

$$\max_{x_0,\ldots,x_T} \sum_{t=0}^{T} C_t(x_t), \tag{1.16}$$

subject to equations (1.13)-(1.15). This is a math program that can be solved with a number of packages.

Now assume that we wish to make $\hat{R}_{t+1}$ a random variable, which means it is not known until time $t+1$. In addition, assume that the price p_t varies randomly over time, which means we do not learn p_{t+1} until time $t+1$. These changes turn the problem into a sequential decision problem under uncertainty.

There are some simple steps to turn this deterministic optimization problem into a fully sequential one under uncertainty. To begin, we write our contribution function as

$$C_t(S_t, x_t) = p_t x_t$$

where the price p_t is random information in the state S_t. We then write the objective function as

$$\max_{\pi} \mathbb{E}\left\{ \sum_{t=0}^{T} C_t(S_t, X^\pi(S_t)) | S_0 \right\}, \tag{1.17}$$

where $X^\pi(S_t)$ has to produce decisions that satisfy the constraints (1.13) - (1.14). Equation (1.15) is represented by the transition function $S^M(S_t, x_t, W_{t+1})$, where W_{t+1} includes $\hat{R}_{t+1}$ and the updated price p_{t+1}. We now have a properly modeled sequential decision problem.

We made the transition from deterministic optimization to a stochastic optimization formulation by making four changes:

- We replaced each occurrence of x_t with the function (policy) $X^\pi(S_t)$.
- We made the contribution function $C_t(x_t)$ depend on the state S_t to capture information (such as the price p_t) that is evolving randomly over time.

- We now take the expectation of the sum of the contributions since the evolution $S_{t+1} = S^M(S_t, x_t, W_{t+1})$ depends on the random variable W_{t+1}. It is helpful to think of the expectation operator $\mathbb{E}$ as averaging all the possible outcomes of the information process $W_1, \ldots, W_T$.

- We replace the $\max_{x_0,\ldots,x_T}$ with $\max_\pi$, which means we switch from finding the best set of *decisions*, to finding the best set of *policies*.

Care has to be taken when converting constraints for deterministic problems to the format we need when there is uncertainty. For example, we might be allocating resources and have to impose a budget over time that we can write as

$$\sum_{t=0}^{T} x_t \quad \leq \quad B,$$

where B is a budget for how much we use over all time periods. This constraint cannot be directly used in a stochastic problem since it assumes that we "decide" the variables $x_0, x_1, \ldots, x_T$ all at the same time. When we have a sequential decision problem, these decisions have to be made sequentially, reflecting the information available at each point in time. We would have to impose budget constraints recursively, as in

$$x_t \quad \leq \quad B - R_t, \tag{1.18}$$

$$R_{t+1} \quad = \quad R_t + x_t. \tag{1.19}$$

In this case, R_t would go into our state variable, and the policy $X^\pi(S_t)$ would have to be designed to reflect the constraint (1.18), while constraint (1.19) is captured by the transition function. Each decision $x_t = X^\pi(S_t)$ has to reflect what is known (captured by S_t) at the time the decision is made.

In practice, computing the expectation is hard (typically impossible) so we resort to methods known as *Monte Carlo simulation*. We introduce these methods in chapter 10. That leaves us with the usual problem of designing the policy. For this, we return to section 1.4.

All optimization problems involve a mixture of modeling and algorithms. With integer programming, modeling is important (especially for integer problems), but modeling has always taken a back seat to the design of algorithms. A testament of the power of modern algorithms is that they generally work well (for a problem class) with modest expertise in modeling strategy.

Sequential decision problems are different.

Figure 1.3 illustrates some of the major differences between how we approach deterministic and stochastic optimization problems:

Models - Deterministic models are systems of equations. Stochastic models are often complex systems of equations, numerical simulators, or even physical systems with unknown dynamics.

Objectives - Deterministic models minimize or maximize some well defined metric such as cost or profit. Stochastic models require that we deal with statistical performance measures and uncertainty operators such as risk. Many stochastic dynamic problems

Figure 1.3 Deterministic vs. stochastic optimization

	Deterministic	Stochastic
Models	System of equations	Complex functions, numerical simulations, physical systems
Objective	Minimize cost	Performance metrics, risk measures
What we are searching for	Real-valued vectors	Functions (policies)
What is hard	Designing algorithms	1) Modeling 2) Designing policies

are quite complicated (think of managing supply chains, trucking companies, energy systems, hospitals, fighting diseases) and involve multiple objectives.

What we are searching for - In deterministic optimization, we are looking for a deterministic scalar or vector. In stochastic optimization, we are almost always looking for functions that we will refer to as policies.

What is hard - The challenge of deterministic optimization is designing an effective algorithm. The hardest part of stochastic optimization, by contrast, is the modeling. Designing and calibrating a stochastic model can be surprisingly difficult. Optimal policies are rare, and a policy is not optimal if the model is not correct.

1.6.4 From single to multiple agents

We close the book by extending these ideas to multiagent systems. Multiagent modeling is effective for breaking up complex systems such as supply chains (where different suppliers operate independently), as well as large transportation networks such as major carriers in trucking and rail. Multiagent modeling is essential in military applications, adversarial settings such as homeland security, oligopolies that describe markets with a small number of competitors, and a host of other applications.

Multiagent modeling is important in problems involving robots, drones and underwater vehicles, which are often used for distributed information collection. For example, a drone might be used to identify areas where wildfires are burning to guide planes and helicopters dropping fire retardant. Robots can be used to sense landmines, and underwater vehicles might be used to collect information about fish populations.

Multiagent settings almost always require learning, since there is an unavoidable compartmentalization of knowledge. This in turn introduces the dimension of communication and coordination, where coordination may be through a central agent, or where we wish to design policies that encourage agents to work together.

We use this chapter to compare our modeling strategy to the most widely used modeling and algorithmic framework for learning systems, known as partially observable Markov decision processes, or POMDPs. This is a mathematically sophisticated theory which does not lead to scalable algorithms. We are going to use our multiagent framework to clarify

knowledge of the transition function, and then draw on all four classes of policies to develop practical, scalable, implementable solutions.

1.7 OUR MODELING APPROACH

The five elements in the modeling framework (section 1.3) can be used to model *any* sequential decision problem, recognizing that there are a variety of objective functions that can be used (these will be covered later). The four classes of policies in section 1.4 cover *any* method that might be used to make decisions in a sequential decision problem.

The four classes of policies are central to our modeling framework in section 1.3. We claim that *any* method used to make decisions for a sequential decision problem (and we mean *any* sequential decision problem) will be made with one of these four classes (or a hybrid of two or more). This represents a major change compared to the approaches used by the communities listed in section 1.2, which are typically associated with a particular solution approach (sometimes more than one).

We note that our approach precisely parallels that used in deterministic optimization, where people write out an optimization model (with decision variables, constraints and an objective) before searching for a solution. This is exactly what we are doing: we are writing out our model without specifying the policy, and then we search for effective policies. We call this approach:

Model first, then solve.

The generality of the four classes of policies is what allows us to separate the process of designing the model (in section 1.3) from the solution of the model (that is, finding an acceptable policy). We will first see this applied in the context of pure learning problems in chapter 7. Next, chapter 8 will present a much richer set of applications, followed by a greatly expanded version of the modeling framework given in chapter 9. Then, after touching on modeling uncertainty in chapter 10, chapter 11 revisits the four classes of policies in more detail. Chapters 12 - 19 describe each of the four classes of policies in depth before transitioning to multiagent systems.

1.8 HOW TO READ THIS BOOK

The book has been carefully designed to present topics in a logical order, with a progression from simpler to more sophisticated concepts. This section provides a guide to how to approach this material.

1.8.1 Organization of topics

The book is organized into six parts, as follows:

Part I - Introduction and foundations - We start by providing a summary of some of the most familiar canonical problems, followed by an introduction to approximation strategies which we draw on throughout the book.

- Canonical problems and applications (chapter 2) - We begin by listing a series of canonical problems that are familiar to different communities, primarily

using the notation familiar to those communities. This is a chapter that can be skimmed by readers new to the general area of stochastic optimization.

- Online learning (chapter 3) - Most books on statistical learning focus on batch applications, where a model is fit to a static dataset. In our work, learning is primarily sequential, known as "online learning" in the machine learning community. Our use of online learning is purely endogenous, in that we do not need an external dataset for training.
- Introduction to stochastic search (chapter 4) - We begin with a problem we call the *basic stochastic optimization problem* which provides the foundation for most stochastic optimization problems. In this chapter we also provide examples of how some problems can be solved exactly. We then introduce the idea of solving sampled models before transitioning to adaptive learning methods, which will be the focus of the rest of the book.

Part II - State-independent problems - There is a wide range of optimization problems where the problem itself is not changing over time (for any reason). All "state-independent problems" are pure learning problems, since all that is changing as a result of our decisions is our belief about the problem. These are also known as stochastic search problems. We defer until Part III the study of more general state-dependent problems, which includes the massive class of dynamic resource allocation problems (where decisions change the allocation of resources), as well as other settings where the problem itself is evolving over time (e.g. changing weather, market prices, temperature in a room, ...).

- Derivative-based stochastic search (chapter 5) - Derivative-based algorithms represent one of the earliest adaptive methods proposed for stochastic optimization. These methods form the foundation of what is classically referred to as (derivative-based) stochastic search, or stochastic gradient algorithms.
- Stepsize policies (chapter 6) - Sampling-based algorithms need to perform smoothing between old and new estimates using what are commonly known as stepsizes (or learning rates). Stepsize policies play a critical role in derivative-based stochastic search, where the stochastic gradient determines the direction in which we move to improve a parameter vector, but the stepsize determines how far we move in the direction of the gradient.
- Derivative-free stochastic search (chapter 7) - We then transition to derivative-free stochastic search, which encompasses a variety of fields with names such as ranking and selection (for offline learning), response surface methods, and multiarmed bandit problems (for online formulations). In this chapter that we demonstrate all four classes of policies for deciding where to next make a (typically noisy) observation of a function that we are trying to optimize.

Part III - State-dependent problems - Here we transition to the much richer class of sequential problems where the *problem* being optimized is evolving over time, which means the *problem* depends on information or parameters that are changing over time. This means the objective function and/or constraints depend on dynamic data in the state variable, where this dynamic data can depend on decisions being made (such as the inventory or location of a drone), or may just evolve exogenously (such as market prices or weather). These problems may or may not have a belief state.

- State-dependent applications (chapter 8) - We begin with a series of applications where the function is state dependent. State variables can arise in the objective function (e.g. prices), or in the constraints, which is typical of problems that involve the management of physical resources. We also illustrate problems that include evolving beliefs, which introduces the dimension of active learning (which we first encounter in chapter 7).
- Modeling sequential decision problems (chapter 9) - This chapter provides a comprehensive summary of how to model general (state-dependent) sequential decision problems. This is a substantial chapter, that starts by illustrating the modeling framework in the context of a simple problem, before exposing the full depth of the modeling framework for complex problems.
- Uncertainty modeling (chapter 10) - To find good policies, you need a good model of uncertainty, which is arguably the most subtle dimension of modeling. In this chapter we identify 12 different sources of uncertainty and discuss how to model them.
- Designing policies (chapter 11) - Here we provide a more comprehensive overview of the different strategies for creating policies, leading to the four classes of policies that we first introduced in part I for learning problems. In this chapter we also provide guidance into how to choose among the four classes for a particular problem, and present the results of a series of experiments on variations of an energy storage problem that show that we can make *each* of the four classes of policies work best depending on the characteristics of the data.

Part IV - Policies based on policy search - These chapters describe policies in the "policy search" class that have to be tuned, either in a simulator or in the field.

- PFAs- Policy function approximations (chapter 12) - In this chapter we consider the use of parametric functions (plus some variations) which directly map from the state variable to a decision, without solving an imbedded optimization problem. This is the only class which does not solve an imbedded optimization problem. We search over a well-defined parameter space to find the policy that produces the best performance over time, in either offline or online settings. PFAs are well suited to problems with scalar action spaces, or low-dimensional continuous actions.
- CFAs- Cost function approximations (chapter 13) - This strategy spans effective policies for solving optimal learning problems (also known as multiarmed bandit problems), to policies for high-dimensional problems that require the use of solvers for linear, integer or nonlinear programs. This policy class has been overlooked in the research literature, but is widely used (heuristically) in industry.

Part V - Policies based on lookahead approximations - Policies based on lookahead approximations are the counterpart to policies derived from policy search. Here, we design good policies by understanding the impact of a decision now on the future. We can do this by finding (usually approximately) the value of being in a state, or by planning over some horizon.

- VFAs- Policies based on value function approximations - This class covers a very rich literature that span exact methods for special cases, and an extensive

literature based on approximating value functions that are described by terms such as approximate dynamic programming, adaptive (or neuro) dynamic programming, and (initially) reinforcement learning. Given the depth and breadth of the work in this area, we cover this class of policy in five chapters:

- Exact dynamic programming (chapter 14) - There are certain classes of sequential decision problems that can be solved exactly. One of the best known is characterized by discrete states and actions (known as discrete Markov decision processes), a topic we cover in considerable depth. We also briefly cover an important problem from the optimal controls literature known as *linear quadratic regulation*, as well as some simple problems that can be solved analytically.
- Backward approximate dynamic programming (chapter 15) - Backward approximate dynamic programming parallels classical backward dynamic programming (from chapter 14), but avoids the need to enumerate states or compute expectations through Monte Carlo sampling and using machine learning to estimate value functions approximately.
- Forward approximate dynamic programming I: The value of a policy (chapter 16) - This is the first step using machine learning methods to approximate the value of policy as a function of the starting state. This is the foundation of a broad class of methods known as approximate (or adaptive) dynamic programming, or reinforcement learning.
- Forward approximate dynamic programming II: Policy optimization (chapter 17) - In this chapter we build on foundational algorithms such as Q-learning, value iteration and policy iteration, first introduced in chapter 14, to try to find high quality policies based on value function approximations.
- Forward approximate dynamic programming III: Convex functions (chapter 18) - This chapter focuses on convex problems, with special emphasis on stochastic linear programs with applications in dynamic resource allocation. Here we exploit convexity to build high quality approximations of value functions.

- DLAs- Policies based on direct lookahead approximations (chapter 19) - A direct lookahead policy optimizes over a horizon, but instead of optimizing the original model, we allow ourselves to introduce a variety of approximations to make it more tractable. A standard approximation is to make the model deterministic, which can work well in some applications. For those where it does not, we revisit the entire process of solving a stochastic optimization problem, but with considerably more emphasis on computation.

Part VI - Multiagent systems and learning - We close by showing how our framework can be extended to handle multiagent systems, which inherently requires learning.

- Multiagent systems and learning (chapter 20) - We start by showing how to model learning systems as two agent problems (a controlling agent observing an environment agent), and show how this produces an alternative framework to partially observable Markov decision processes (known as POMDPs). We then extend to problems with multiple controlling agents, in particular the need to model communication.

1.8.2 How to read each chapter

This book covers a lot of material, which should not be surprising given the scope of the topic. However, it has been written to "read short." In every chapter, there are sections marked by "*" - this is our indication of material that can be skipped on a first pass.

There are a few sections marked with ** which is our indication of mathematically advanced material. For mathematically sophisticated readers (especially those with a measure-theoretic probability background), there are many opportunities to approach this material using the full range of this training. This book is not designed for these readers, although we will occasionally hint at this material. We will say, however, that much of our notational style has been designed with an understanding of how probabilists (in particular) think of and approach sequential decision problems. This book will lay a proper foundation for readers who want to use this as a launching pad into more theoretical research.

Readers new to the entire topic of sequential decision problems (and by this we mean any form of dynamic programming, stochastic programming and stochastic control) should start with the relatively simpler "starter" models. It is quite easy to learn how to model the simpler problems. By contrast, complex problems can become quite rich, especially when it comes to developing stochastic models. It is important to find the problems that you are comfortable with, and then grow from there.

The book will talk at length about the four classes of policies. Of these, two are relatively simple (PFAs and CFAs) and two are much richer (VFAs and stochastic DLAs). You should not assume that you need to become an expert in all of them right away. Everyone makes decisions over time in the presence of evolving information, and the vast majority of these people have never heard of Bellman's equation (VFA-based policies). Also, while deterministic DLAs (think of navigation systems planning a path) are also relatively easy to understand, stochastic DLAs are another matter. It is much more important to get an understanding of the concept of a policy and tuning a policy (which you can do using PFAs and CFAs) than it is to jump into the more complex policies that are popular in the academic literature (VFAs and stochastic DLAs).

1.8.3 Organization of exercises

Each chapter is accompanied by a series of exercises at the end of the chapter, divided into the following categories:

- Review questions - These are relatively simple questions drawn directly from the chapter, without any need for creative problem solving.
- Modeling questions - These will be questions that describe an application which you then have to put into the modeling framework given above.
- Computational exercises - These are exercises that require that you perform specific calculations related to methods described in the chapter.
- Theory questions - From time to time we will pose classical theory questions. Most texts on stochastic optimization emphasize these questions. This book emphasizes modeling and computation, so theory questions play a relatively minor role.
- Problem solving questions - These questions will pose a setting and require that you go through modeling and policy design.

- Readings from *Sequential Decision Analytics and Modeling* - This is an online book that uses a teach by example style. Each chapter (except for chapters 1 and 7) illustrates how to model and solve a specific decision problem. These have been designed to bring out the features of different classes of policies. There are Python modules that go with most of these exercises that provide an opportunity to do computational work. These exercises will generally require that the reader use the Python module as a start, but where additional programming is required.

- Diary problem - This is a single problem of your choosing that you will use as a context to answer a question at the end of each chapter. It is like "keeping a diary" since you will accumulate answers that draw from the material throughout the book, but using the setting of a problem that is relevant to you.

Not all of these topics will be included in the exercises for each chapter.

1.9 BIBLIOGRAPHIC NOTES

Section 1.2 - We defer to chapter 2 for a discussion of the different communities of stochastic optimization, and review the literature there. It cannot be emphasized enough how much our universal framework draws on all these communities.

Section 1.3 - We first articulated the five elements of the universal framework in Powell (2011) (Chapter 5, which has always been available at `http://adp.princeton.edu`), which built on the initial model from the first edition which had six elements (Powell (2007)). Our framework draws heavily from the framework that has long been used in optimal control (there are many books, but see Lewis & Vrabie (2012) which is a popular reference in this field), but there are some differences. Our framework is compared to the optimal control framework and that used in Markov decision processes (and now reinforcement learning) in Powell (2021). Some key differences is that the optimal control framework, which is originally based on deterministic control, often optimizes over the controls $u_0, u_1, \ldots, u_T$, even when the problem is stochastic. Our notation makes it explicit that if the problem is stochastic, u_t is a function which we call a policy (the controls people will call it a control law), and we always optimizes over policies π.

Section 1.4 - Powell (2011) appears to be the first published reference to "four classes of policies" for solving dynamic programs, but it did not list the four classes used here (one class was myopic policies, and cost function approximations were overlooked). The first reference to list the four classes of policies used here was the tutorial Powell (2014) *Clearing the Jungle of Stochastic Optimization*, without recognizing that the four classes can (and should) be divided into two major strategies. The first paper to identify the two strategies of "policy search" and "lookahead policies" was given in the tutorial Powell (2016). All these ideas came together in Powell (2019) which combined the four classes of policies with the identification of state-independent and state-dependent problem classes, along with different types of objectives such as cumulative and final reward. This paper laid the foundation for this book.

EXERCISES

Review questions

1.1 What are the three classes of state variables?

1.2 What are the five elements of a sequential decision problem?

1.3 What is meant by "model first, then solve"?

1.4 What is the price of simplicity? Give an example, either from the chapter or a problem of your own choosing.

1.5 What are the two strategies for designing policies for sequential decision problems? Briefly describe the principles behind each one.

1.6 What are the four classes of policies? Briefly describe each one.

Modeling questions

1.7 Pick three examples of sequential decision problems. Provide a brief narrative describing the context, and list a) the decision being made, b) information that arrives after the decision is made that is likely to be relevant to the decision, and c) at least one metric that can be used to evaluate how well the decision has performed.

1.8 For each of the three types of state variables, do the following:

a) Give three examples of physical state variables.

b) Give three examples of information about parameters or quantities that we know perfectly, but which would not be considered a physical state variable.

c) Give three examples of parameters or quantities that we would not know perfectly, but could approximate with a probability distribution.

1.9 Section 1.3 shows how to model a simple inventory problem. Repeat this model assuming that we sell our product at a price p_t that changes from time period to time period according to the equation

$$p_{t+1} = p_t + \varepsilon_{t+1},$$

where ε_{t+1} is a normally distributed random variable with mean 0 and variance σ^2.

Problem solving questions

1.10 Consider an asset selling problem where you need to decide when to sell an asset. Let p_t be the price of the asset if it is sold at time t, and assume that you model the evolution of the price of the asset using

$$p_{t+1} = p_t + \theta(p_t - 60) + \varepsilon_{t+1},$$

We assume that the noise terms $\varepsilon_t,\ t = 1, 2, \ldots$ are independent and identically distributed over time, where $\varepsilon_t \sim N(0, \sigma_\varepsilon^2)$. Let

$$R_t = \begin{cases} 1 & \text{if we are still holding the asset at time } t, \\ 0 & \text{otherwise.} \end{cases}$$

Further let

$$x_t = \begin{cases} 1 & \text{if we sell the asset at time } t, \\ 0 & \text{Otherwise.} \end{cases}$$

Of course, we can only sell the asset if we are still holding it. We now need a rule for deciding if we should sell the asset. We propose

$$X^\pi(S_t|\rho) = \begin{cases} 1 & \text{If } p_t \geq \bar{p}_t + \rho \text{ and } R_t = 1, \\ 0 & \text{otherwise.} \end{cases}$$

where

$$\begin{aligned} S_t &= \text{the information we have available to make a decision (we have to, design this),} \\ \bar{p}_t &= .9\bar{p}_{t-1} + .1p_t. \end{aligned}$$

a) What are the elements of the state variable S_t for this problem?

b) What is the uncertainty?

c) Imagine running a simulation in a spreadsheet where you are given a sample realization of the noise terms over T time periods as $(\hat{\varepsilon})_{t=1}^T = (\hat{\varepsilon}_1, \hat{\varepsilon}_2, \ldots, \hat{\varepsilon}_T)$. Note that we treat $\hat{\varepsilon}_t$ as a number, such as $\hat{\varepsilon}_t = 1.67$ as opposed to ε_t which is a normally distributed random variable. Write an expression for computing the value of the policy $X^\pi(S_t|\rho)$ given the sequence $(\hat{\varepsilon})_{t=1}^T$. Given this sequence, we could evaluate different values of ρ, say $\rho = 0.75, 2.35$ or 3.15 to see which performs the best.

d) In reality, we are not going to be given the sequence $(\hat{\varepsilon})_{t=1}^T$. Assume that $T = 20$ time periods, and that

$$\begin{aligned} \sigma_\varepsilon^2 &= 4^2, \\ p_0 &= \$65, \\ \theta &= 0.1. \end{aligned}$$

Write out the value of the policy as an expectation (see section 1.3).

e) Develop a spreadsheet to create 10 sample paths of the sequence $(\varepsilon_t),\ t = 1, \ldots, 20)$ using the parameters above. You can generate a random observation of ε_t using the function `NORM.INV(RAND(),0,`σ`)`. Let the performance of our decision rule $X^\pi(S_t|\rho)$ be given by the price that it decides to sell (if it decides to sell), averaged over all 10 sample paths. Now test $\rho = 1, 2, 3, 4, ..., 10$ and find the value of ρ that seems to work the best.

f) Repeat (e), but this time we are going to solve the problem

$$\max_{x_0,\ldots,x_T} \mathbb{E} \sum_{t=0}^{T} p_t x_t.$$

We do this by picking the time t when we are going to sell (that is, when $x_t = 1$) before seeing any information. Evaluate the solutions $x_2 = 1, x_4 = 1, \ldots, x_{20} = 1$. Which is best? How does its performance compare to the performance of $X^\pi(S_t|\rho)$ for the best value of ρ?

g) Finally, repeat (f), but now you get to see all the prices and then pick the best one. This is known as a *posterior bound* because it gets to see all the information in the future to make a decision now. How do the solutions in parts (e) and (f) compare to the posterior bound? (There is an entire field of stochastic optimization that uses this strategy as an approximation.)

h) Classify the policies in (e), (f) and (g) (yes, (g) is a class of policy) according to the classification described in section 1.5 of the text.

1.11 The inventory problem describes a policy where an order is made if the inventory falls below θ^{min}, where we order up to θ^{max}. Which of the four classes does this represent? Write out the objective function we would have to use to find the best value of θ.

Sequential decision analytics and modeling

These exercises are drawn from the online book *Sequential Decision Analytics and Modeling* available at `http://tinyurl.com/sdaexamplesprint`.

1.12 Read chapter 2 on the asset selling problem (sections 2.1 - 2.4).

a) Which of the four classes of policies introduced in section 1.4 are used for this problem?

b) What tunable parameters are used in the policy?

c) Describe the process you might use for tuning the policy using historical data.

Diary problem

The diary problem is a single problem you chose (see chapter 1 for guidelines). Answer the following for your diary problem.

1.13 For this chapter, you need to pick a problem context. The ideal problem is one with some richness (e.g. different types of decisions and sources of uncertainty), but the best problem is one that you are familiar with, or have a special interest in. To bring out the richness of our modeling and algorithmic framework, it would help if your sequential

decision problem involved learning in some form. For now, prepare a 1-2 paragraph summary of the context. You will be providing additional details in later chapters.

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