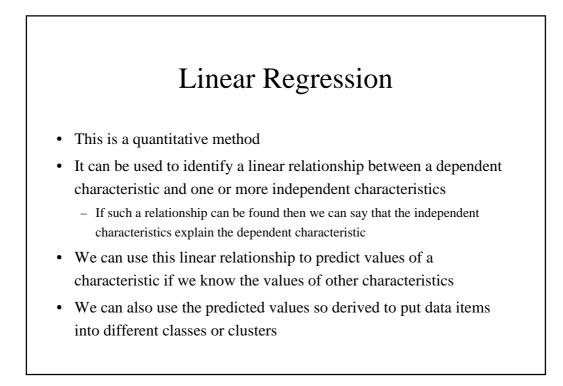
Regression

- Regression is a predictive method (like the nearest neighbour algorithm)
- The approach is to try to describe a **dependent** variable in terms of one or more **independent** variables
- Regression can be used with both quantitative and qualitative data



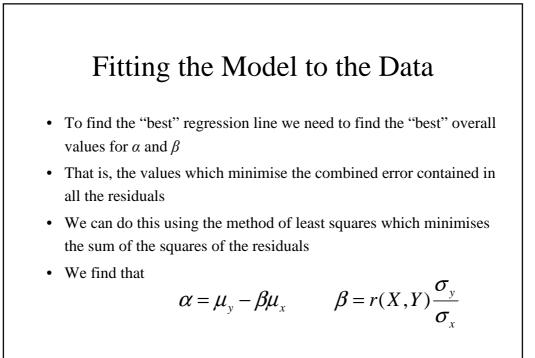
The Linear Regression Model

- The basic model deals with the case where we have just one independent variable or characteristic, X, which explains a dependent variable or characteristic, Y
- Given *n* pairs of observations for the dependent and independent variables (x_p, y_i) we can relate them to each other with a regression function

$$y_i = \alpha + \beta x_i + \varepsilon_i$$

- That is, a straight line where ε_i absorbs the divergence from the straight line, or residual, for each pair of observations
- The regression function is a combination of the residuals and the regression line (or approximation)

$$\hat{y}_i = \alpha + \beta x_i$$



Residual Analysis I

- The residuals, ε_i, can tell us a lot about how well our linear model describes the dependent variable, Y, in terms of the independent variable, X
- Having found the best values for α and β the sum of the residuals will be zero because the errors will be equally spread either side (positive and negative) of the regression line but there may still be a pattern in the sign or magnitude of the residuals with respect to certain subsets of the observed values
- Such patterns would indicate that our model may be over-simplistic
- The residuals will be uncorrelated with both X and Y overall but this does not mean that they will be uncorrelated with all subsets of the observed values
- Where subset correlations exist we have evidence that our model could be improved upon

Residual Analysis II

- Finally, although we know that the method of least squares has provided the best *linear* fit to our observed data, we don't know how good this linear fit is our observed data *may not be linear*
- Consider the following relation that follows directly from the regression line

$$\sum (y_{i} - \bar{y})^{2} = \sum (\hat{y}_{i} - \bar{y})^{2} + \sum (y_{i} - \hat{y}_{i})^{2}$$

• In words it is saying that the total sum of squares in the observations is equal the sum of squares of the regression (approximation) plus the sum of squares of the errors

Residual Analysis III

• If we divide these deviances by the number of observations, *n*, we will get

$$Var(Y) = Var(Y) + Var(E)$$

- That is, the variance in the dependent variable comes from the variance explained by the regression line and the residual variance
- Consider now $R^{2} = \frac{Var(\hat{Y})}{Var(Y)} = 1 \frac{Var(E)}{Var(Y)}$
- This is the square of the linear correlation coefficient and will by 0 when the regression line is constant (the gradient is 0) and it will be 1 when the regression line is a perfect fit (the residuals are 0)
- So the closer R^2 is to 1 the better our regression model is

