

An Introduction to Stochastic Modeling

An Introduction to Stochastic Modeling

Fourth Edition

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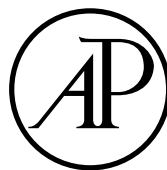
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Contents

Preface to the Fourth Edition	xi
Preface to the Third Edition	xiii
Preface to the First Edition	xv
To the Instructor	xvii
Acknowledgments	xix
1 Introduction	1
1.1 Stochastic Modeling	1
1.1.1 Stochastic Processes	4
1.2 Probability Review	4
1.2.1 Events and Probabilities	4
1.2.2 Random Variables	5
1.2.3 Moments and Expected Values	7
1.2.4 Joint Distribution Functions	8
1.2.5 Sums and Convolutions	10
1.2.6 Change of Variable	10
1.2.7 Conditional Probability	11
1.2.8 Review of Axiomatic Probability Theory	12
1.3 The Major Discrete Distributions	19
1.3.1 Bernoulli Distribution	20
1.3.2 Binomial Distribution	20
1.3.3 Geometric and Negative Binominal Distributions	21
1.3.4 The Poisson Distribution	22
1.3.5 The Multinomial Distribution	24
1.4 Important Continuous Distributions	27
1.4.1 The Normal Distribution	27
1.4.2 The Exponential Distribution	28
1.4.3 The Uniform Distribution	30
1.4.4 The Gamma Distribution	30
1.4.5 The Beta Distribution	31
1.4.6 The Joint Normal Distribution	31
1.5 Some Elementary Exercises	34
1.5.1 Tail Probabilities	34
1.5.2 The Exponential Distribution	37
1.6 Useful Functions, Integrals, and Sums	42

2	Conditional Probability and Conditional Expectation	47
2.1	The Discrete Case	47
2.2	The Dice Game Craps	52
2.3	Random Sums	57
2.3.1	Conditional Distributions: The Mixed Case	58
2.3.2	The Moments of a Random Sum	59
2.3.3	The Distribution of a Random Sum	61
2.4	Conditioning on a Continuous Random Variable	65
2.5	Martingales	71
2.5.1	The Definition	72
2.5.2	The Markov Inequality	73
2.5.3	The Maximal Inequality for Nonnegative Martingales	73
3	Markov Chains: Introduction	79
3.1	Definitions	79
3.2	Transition Probability Matrices of a Markov Chain	83
3.3	Some Markov Chain Models	87
3.3.1	An Inventory Model	87
3.3.2	The Ehrenfest Urn Model	89
3.3.3	Markov Chains in Genetics	90
3.3.4	A Discrete Queueing Markov Chain	92
3.4	First Step Analysis	95
3.4.1	Simple First Step Analyses	95
3.4.2	The General Absorbing Markov Chain	102
3.5	Some Special Markov Chains	111
3.5.1	The Two-State Markov Chain	112
3.5.2	Markov Chains Defined by Independent Random Variables	114
3.5.3	One-Dimensional Random Walks	116
3.5.4	Success Runs	120
3.6	Functionals of Random Walks and Success Runs	124
3.6.1	The General Random Walk	128
3.6.2	Cash Management	132
3.6.3	The Success Runs Markov Chain	134
3.7	Another Look at First Step Analysis	139
3.8	Branching Processes	146
3.8.1	Examples of Branching Processes	147
3.8.2	The Mean and Variance of a Branching Process	148
3.8.3	Extinction Probabilities	149
3.9	Branching Processes and Generating Functions	152
3.9.1	Generating Functions and Extinction Probabilities	154
3.9.2	Probability Generating Functions and Sums of Independent Random Variables	157
3.9.3	Multiple Branching Processes	159

4	The Long Run Behavior of Markov Chains	165
4.1	Regular Transition Probability Matrices	165
4.1.1	Doubly Stochastic Matrices	170
4.1.2	Interpretation of the Limiting Distribution	171
4.2	Examples	178
4.2.1	Including History in the State Description	178
4.2.2	Reliability and Redundancy	179
4.2.3	A Continuous Sampling Plan	181
4.2.4	Age Replacement Policies	183
4.2.5	Optimal Replacement Rules	185
4.3	The Classification of States	194
4.3.1	Irreducible Markov Chains	195
4.3.2	Periodicity of a Markov Chain	196
4.3.3	Recurrent and Transient States	198
4.4	The Basic Limit Theorem of Markov Chains	203
4.5	Reducible Markov Chains	215
5	Poisson Processes	223
5.1	The Poisson Distribution and the Poisson Process	223
5.1.1	The Poisson Distribution	223
5.1.2	The Poisson Process	225
5.1.3	Nonhomogeneous Processes	226
5.1.4	Cox Processes	227
5.2	The Law of Rare Events	232
5.2.1	The Law of Rare Events and the Poisson Process	234
5.2.2	Proof of Theorem 5.3	237
5.3	Distributions Associated with the Poisson Process	241
5.4	The Uniform Distribution and Poisson Processes	247
5.4.1	Shot Noise	253
5.4.2	Sum Quota Sampling	255
5.5	Spatial Poisson Processes	259
5.6	Compound and Marked Poisson Processes	264
5.6.1	Compound Poisson Processes	264
5.6.2	Marked Poisson Processes	267
6	Continuous Time Markov Chains	277
6.1	Pure Birth Processes	277
6.1.1	Postulates for the Poisson Process	277
6.1.2	Pure Birth Process	278
6.1.3	The Yule Process	282
6.2	Pure Death Processes	286
6.2.1	The Linear Death Process	287
6.2.2	Cable Failure Under Static Fatigue	290

6.3	Birth and Death Processes	295
6.3.1	Postulates	295
6.3.2	Sojourn Times	296
6.3.3	Differential Equations of Birth and Death Processes	299
6.4	The Limiting Behavior of Birth and Death Processes	304
6.5	Birth and Death Processes with Absorbing States	316
6.5.1	Probability of Absorption into State 0	316
6.5.2	Mean Time Until Absorption	318
6.6	Finite-State Continuous Time Markov Chains	327
6.7	A Poisson Process with a Markov Intensity	338
7	Renewal Phenomena	347
7.1	Definition of a Renewal Process and Related Concepts	347
7.2	Some Examples of Renewal Processes	353
7.2.1	Brief Sketches of Renewal Situations	353
7.2.2	Block Replacement	354
7.3	The Poisson Process Viewed as a Renewal Process	358
7.4	The Asymptotic Behavior of Renewal Processes	362
7.4.1	The Elementary Renewal Theorem	363
7.4.2	The Renewal Theorem for Continuous Lifetimes	365
7.4.3	The Asymptotic Distribution of $N(t)$	367
7.4.4	The Limiting Distribution of Age and Excess Life	368
7.5	Generalizations and Variations on Renewal Processes	371
7.5.1	Delayed Renewal Processes	371
7.5.2	Stationary Renewal Processes	372
7.5.3	Cumulative and Related Processes	372
7.6	Discrete Renewal Theory	379
7.6.1	The Discrete Renewal Theorem	383
7.6.2	Deterministic Population Growth with Age Distribution	384
8	Brownian Motion and Related Processes	391
8.1	Brownian Motion and Gaussian Processes	391
8.1.1	A Little History	391
8.1.2	The Brownian Motion Stochastic Process	392
8.1.3	The Central Limit Theorem and the Invariance Principle	396
8.1.4	Gaussian Processes	398
8.2	The Maximum Variable and the Reflection Principle	405
8.2.1	The Reflection Principle	406
8.2.2	The Time to First Reach a Level	407
8.2.3	The Zeros of Brownian Motion	408
8.3	Variations and Extensions	411
8.3.1	Reflected Brownian Motion	411
8.3.2	Absorbed Brownian Motion	412
8.3.3	The Brownian Bridge	414
8.3.4	Brownian Meander	416

8.4	Brownian Motion with Drift	419
8.4.1	The Gambler's Ruin Problem	420
8.4.2	Geometric Brownian Motion	424
8.5	The Ornstein–Uhlenbeck Process	432
8.5.1	A Second Approach to Physical Brownian Motion	434
8.5.2	The Position Process	437
8.5.3	The Long Run Behavior	439
8.5.4	Brownian Measure and Integration	441
9	Queueing Systems	447
9.1	Queueing Processes	447
9.1.1	The Queueing Formula $L = \lambda W$	448
9.1.2	A Sampling of Queueing Models	449
9.2	Poisson Arrivals, Exponential Service Times	451
9.2.1	The $M/M/1$ System	452
9.2.2	The $M/M/\infty$ System	456
9.2.3	The $M/M/s$ System	457
9.3	General Service Time Distributions	460
9.3.1	The $M/G/1$ System	460
9.3.2	The $M/G/\infty$ System	465
9.4	Variations and Extensions	468
9.4.1	Systems with Balking	468
9.4.2	Variable Service Rates	469
9.4.3	A System with Feedback	470
9.4.4	A Two-Server Overflow Queue	470
9.4.5	Preemptive Priority Queues	472
9.5	Open Acyclic Queueing Networks	480
9.5.1	The Basic Theorem	480
9.5.2	Two Queues in Tandem	481
9.5.3	Open Acyclic Networks	482
9.5.4	Appendix: Time Reversibility	485
9.5.5	Proof of Theorem 9.1	487
9.6	General Open Networks	488
9.6.1	The General Open Network	492
10	Random Evolutions	495
10.1	Two-State Velocity Model	495
10.1.1	Two-State Random Evolution	498
10.1.2	The Telegraph Equation	500
10.1.3	Distribution Functions and Densities in the Two-State Model	501
10.1.4	Passage Time Distributions	505
10.2	N -State Random Evolution	507
10.2.1	Finite Markov Chains and Random Velocity Models	507
10.2.2	Constructive Approach of Random Velocity Models	507

10.2.3	Random Evolution Processes	508
10.2.4	Existence-Uniqueness of the First-Order System (10.26)	509
10.2.5	Single Hyperbolic Equation	510
10.2.6	Spectral Properties of the Transition Matrix	512
10.2.7	Recurrence Properties of Random Evolution	515
10.3	Weak Law and Central Limit Theorem	516
10.4	Isotropic Transport in Higher Dimensions	521
10.4.1	The Rayleigh Problem of Random Flights	521
10.4.2	Three-Dimensional Rayleigh Model	523
11	Characteristic Functions and Their Applications	525
11.1	Definition of the Characteristic Function	525
11.1.1	Two Basic Properties of the Characteristic Function	526
11.2	Inversion Formulas for Characteristic Functions	527
11.2.1	Fourier Reciprocity/Local Non-Uniqueness	530
11.2.2	Fourier Inversion and Parseval's Identity	531
11.3	Inversion Formula for General Random Variables	532
11.4	The Continuity Theorem	533
11.4.1	Proof of the Continuity Theorem	534
11.5	Proof of the Central Limit Theorem	535
11.6	Stirling's Formula and Applications	536
11.6.1	Poisson Representation of $n!$	537
11.6.2	Proof of Stirling's Formula	538
11.7	Local deMoivre–Laplace Theorem	539
	Further Reading	541
	Answers to Exercises	543
	Index	557

Preface to the Fourth Edition

Since the publication of the third edition in 1998, some new developments have occurred. Samuel Karlin died in 2007, leaving a gap at the authorship level and the new designation of authors.

In the fourth edition, we have added two new chapters: Chapter 10 on random evolution and Chapter 11 on characteristic functions. *Random Evolution* denotes a set of stochastic models, which describe continuous motion with piecewise linear sample functions. Explicit formulas are available in the simplest cases. In the general case, one has a central limit theorem, which is pursued more generally in Chapter 11, “Characteristic Functions and Their Applications.” Here the necessary tools from Fourier Analysis are developed and applied when necessary. Many theorems are proved in full detail, while other proofs are sketched—in the spirit of the earlier Chapters 1–9. Complete proofs may be found by consulting the intermediate textbooks listed in the section on further reading. Instructors who have taught from the third edition may be reassured that Chapters 1–9 of the new edition are identical to the corresponding chapters of the new book.

We express our thanks to Michael Perlman of the University of Washington and Russell Lyons of Indiana University for sharing their lists of errata from the third edition. We would also like to thank Craig Evans for useful advice on partial differential equations.

Biographical Note

Samuel Karlin earned his undergraduate degree from the Illinois Institute of Technology and his doctorate from Princeton University in 1947 at age 22. He served on the faculty of Caltech from 1948–1956 before joining the faculty of Stanford University, where he spent the remainder of his career. Karlin made fundamental contributions to mathematical economics, bioinformatics, game theory, evolutionary theory, biomolecular sequence analysis, mathematical population genetics, and total positivity.

Karlin authored 10 books and more than 450 articles. He was a member of the American Academy of Arts and Sciences and the National Academy of Sciences. In 1989, he received the National Medal of Science for his broad and remarkable researches in mathematical analysis, probability theory, and mathematical statistics and in the application of these ideas to mathematical economics, mechanics, and genetics. He died on December 18, 2007.

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Preface to the Third Edition

The purposes, level, and style of this new edition conform to the tenets set forth in the original preface. We continue with our objective of introducing some theory and applications of stochastic processes to students having a solid foundation in calculus and in calculus-level probability, but who are not conversant with the “epsilon–delta” definitions of mathematical analysis. We hope to entice students toward the deeper study of mathematics that is prerequisite to further work in stochastic processes by showing the myriad and interesting ways in which stochastic models can help us understand the real world.

We have removed some topics and added others. We added a small section on martingales that includes an example suggesting the martingale concept as appropriate for modeling the prices of assets traded in a perfect market. A new chapter introduces the Brownian motion process and includes several applications of it and its variants in financial modeling. In this chapter the Black–Scholes formula for option pricing is evaluated and compared with some reported prices of options. A Poisson process whose intensity is itself a stochastic process is described in another new section.

Some treatments have been updated. The law of rare events is presented via an inequality that measures the accuracy of a Poisson approximation for the distribution of the sum of independent, not necessarily identically distributed, Bernoulli random variables. We have added the shot noise model and related it to a random sum.

The text contains more than 250 exercises and 350 problems. Exercises are elementary drills intended to promote active learning and to develop familiarity with concepts through use. They often simply involve the substitution of numbers into given formulas or reasoning one or two steps away from a definition. They are the kinds of simple questions that we, as instructors, hope that students would pose and answer for themselves as they read a text. Answers to the exercises are given at the end of the book so that students may gauge their understanding as they go along.

Problems are more difficult. Some involve extensive algebraic or calculus manipulation. Many are “word problems” wherein the student is asked, in effect, to model some described scenario. As in formulating a model, the first step in the solution of a word problem is often a sentence of the form “Let $x = \dots$.” A manual containing the solutions to the problems is available from the publisher.

A reasonable strategy on the part of the teacher might be to hold students responsible for all of the exercises, but to require submitted solutions only to selected problems. Every student should attempt a representative selection of the problems in order to develop his or her ability to carry out stochastic modeling in his or her area of interest.

A small number of problems are labeled “Computer Challenges.” These call for more than pencil and paper for their analyses, and either simulation, numerical exploration, or symbol manipulation may prove helpful. Computer Challenges are meant to be open-ended, intended to explore what constitutes an answer in today’s world of computing power. They might be appropriate as part of an honors requirement.

Because our focus is on stochastic modeling, in some instances, we have omitted a proof and contented ourselves with a precise statement of a result and examples of its application. All such omitted proofs may be found in *A First Course in Stochastic Processes*, by the present authors. In this more advanced text, the ambitious student will also find additional material on martingales, Brownian motion, and renewal processes, and presentations of several other classes of stochastic processes.

Preface to the First Edition

Stochastic processes are ways of quantifying the dynamic relationships of sequences of random events. Stochastic models play an important role in elucidating many areas of the natural and engineering sciences. They can be used to analyze the variability inherent in biological and medical processes, to deal with uncertainties affecting managerial decisions and with the complexities of psychological and social interactions, and to provide new perspectives, methodology, models, and intuition to aid in other mathematical and statistical studies.

This book is intended as a beginning text in stochastic processes for students familiar with elementary probability calculus. Its aim is to bridge the gap between basic probability know-how and an intermediate-level course in stochastic processes—for example, *A First Course in Stochastic Processes*, by the present authors.

The objectives of this book are as follows: (1) to introduce students to the standard concepts and methods of stochastic modeling; (2) to illustrate the rich diversity of applications of stochastic processes in the sciences; and (3) to provide exercises in the application of simple stochastic analysis to appropriate problems.

The chapters are organized around several prototype classes of stochastic processes featuring Markov chains in discrete and continuous time, Poisson processes and renewal theory, the evolution of branching events, and queueing models. After the concluding Chapter 9, we provide a list of books that incorporate more advanced discussions of several of the models set forth in this text.

To the Instructor

If possible, we recommend having students skim the first two chapters, referring as necessary to the probability review material, and starting the course with Chapter 3, on Markov chains. A one-quarter course adapted to the junior–senior level could consist of a cursory (1-week) review of Chapters 1 and 2, followed in order by Chapters 3 through 6. For interested students, Chapters 7, 8, and 9 discuss other currently active areas of stochastic modeling. Starred sections contain material of a more advanced or specialized nature.

Acknowledgments

Many people helped to bring this text into being. We gratefully acknowledge the help of Anna Karlin, Shelley Stevens, Karen Larsen, and Laurieann Shoemaker. Chapter 9 was enriched by a series of lectures on queueing networks given by Ralph Disney at The Johns Hopkins University in 1982. Alan Karr, Ivan Johnstone, Luke Tierney, Bob Vanderbei, and others besides ourselves have taught from the text, and we have profited from their criticisms. Finally, we are grateful for improvements suggested by the several generations of students who have used the book over the past few years and have given us their reactions and suggestions.