

## LECTURE 09: CONFIDENCE INTERVALS I

- I. The Meaning of Confidence
  - a. When we take a sample, we often summarize it with the sample's mean. This is an example of a *point estimate*—a single value that best describes the population.
  - b. The problem is, our sample may be unusual. Remember the Central Limit Theorem? Sample means form a normal distribution. Our sample mean, and therefore our sample, could be unusual.
  - c. We correct this with a confidence interval. A *confidence interval for the mean* is the range where the true population mean lies.
    - i. For example, the confidence interval for how customers feel about your restaurant is between 7.4 and 8.1.
  - d. The *confidence level* is the probability that the interval estimate will include the population parameter of interest (e.g. the population mean).
    - i. For example, 90% confidence means that if you took 100 samples, 90 of those samples' means would lie within the confidence interval.
    - ii. In other words, at this probability, the  $\mu$  is in this interval.
    - iii. “Confidence” in statistics is not an emotional state. It's a reference to the probability of where the true parameter lies.
- II. Z-scores
  - a. Z-scores are critical to confidence intervals. Indeed, we call them *critical values* because that is the threshold value. For example, what should have a larger range: 90% confidence or 99% confidence?
    - i. Both are useful. 90% confidence narrows the choices of where the true parameter lies but 99% confidence will have a larger range and thus you'll be more likely to include where the true value is.
    - ii. The question becomes, how do you mathematically capture that change from 90% to 99%?
  - b. Z-scores are basically standard deviations. That means at a z-score of 2, 95% of observations are within two standard deviations. Every confidence rating has a z-score associated with it.
    - i. Technically, 95% confidence is a z-score of 1.96.

- c. The Greek letter  $\alpha$  (alpha) is the *significance level*; it's equal to  $1 - \text{confidence level}$ . For example, at 90% confidence,  $\alpha = 0.10$ .
  - i. Because there are two sides of the normal distribution,  $\alpha$  is sometimes divided by two to indicate the area for alpha is split in half:  $\alpha/2$ .
  - ii. Every critical value has a corresponding z-score,  $z_{\alpha/2}$ . Below is a table of regularly used z-scores.

<i>Confidence</i>	$\alpha$	$z_{\alpha/2}$
90%	10%	1.645
95%	5%	1.960
99%	1%	2.576
99.9%	0.1%	3.291

- iii. As a life skill, it's useful to memorize this list even if you only memorize it out to two decimal places rather than three.

### III. Calculating the Margin of Error with Known $\sigma$

- a. The *margin of error* determines the width of a confidence interval; it is the distance between an upper or lower bound and the mean.
  - i. Because the normal distribution is symmetric, the distance between the upper bound and the sample mean equals the distance between the lower bound and the sample mean.
  - ii. Twice the margin of error is the range of the confidence interval.
- b. When the population standard deviation ( $\sigma$ ) is known, the equation for a confidence interval is this:

$$CI_{\bar{x}} = \bar{x} \mp z_{\alpha/2} \left( \frac{\sigma}{\sqrt{n}} \right)$$

- i. Where  $CI_{\bar{x}}$  is the confidence interval for the sample mean;
- ii.  $\bar{x}$  is the sample mean;
- iii.  $z_{\alpha/2}$  is the critical value for  $\alpha$  significance level;
- iv.  $\sigma$  is the population's standard deviation; and
- v.  $n$  is the sample size.
- vi. Note the minus/plus sign means you subtract (to get the lower bound) and add (to get the upper bound).
- vii. The margin of error is everything after the minus/plus sign.
- c. You typically know  $\sigma$  concerning well-established data. This includes blood pressure, stock market prices, or any other data that's calculated regularly and for a long period of time.

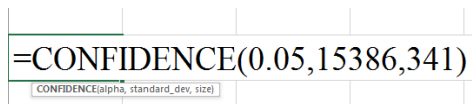
- d. But knowing  $\sigma$  means you know  $\mu$  (recall you need  $\mu$  to calculate  $\sigma$ ) so a confidence interval isn't as useful here.
  - i. Sometimes  $\mu$  changes and we have good reason to think  $\sigma$  didn't change—like shifting the entire normal distribution right or left—so this there's still a use for what we just covered.

#### IV. Confidence in Excel

- a. Excel's confidence function calculates the margin of error; you subtract from and add to the mean yourself.
- b. The good news is that Excel has all z-scores for *any* alpha built in. So not only do you just need to supply the alpha, you are not limited to the 0.10, 0.05, 0.01, 0.001 alphas.
- c. The command is “=CONFIDENCE”
  - i. *Alpha* is the significance level, expressed as a decimal.
  - ii. *Standard\_dev* is the standard deviation of the population
  - iii. *Size* is the sample size.

#### V. Example

- a. Theo works at Friendly Friends, a toy company. Every few years the company makes slight alterations to its teddy bear (it's their best selling product). While most changes increase sales and a few decrease sales, the standard deviation of sales is always more or less the same: 15,386.
- b. The company just made a change to the bear and Theo needs to figure out how many bears to make for the holiday season. He first runs several focus groups. Based on the input of 341 people, he estimates they will sell an average of 413,512 bears. At 95% confidence, what's the confidence interval?
- c. Type “=CONFIDENCE(0.05,15386,341)” into Excel and press ENTER. You should get about 1,633.



- i. Therefore, they should make between 411,879 and 415,145 bears. If they want to make sure they have enough bears in stock, the upper limit is where they want to be.
- d. Now change the alpha value to a cell reference (I used A2, as shown) and put 0.05 there. Then add 0.01 in the cell below that and 0.001 in the cell below that.

	A	B		A	B
1	<b>Alpha</b>	<b>Margin of Error</b>	1	<b>Alpha</b>	<b>Margin of Error</b>
2	0.05	1633.039	2	0.05	1633.039
3	0.01		3	0.01	2146.177
4	0.001		4	0.001	2741.662

- e. Note that as the significance level falls (and thus the confidence level increases), the greater the margin of error.
- i. This highlights the conflict when choosing a significance level. The lower the level, the better chance you will capture the true mean. But the bigger the margin of error, the vaguer the confidence interval.