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## SOME THOUGHTS ABOUT THE DESIGN OF LOSS FUNCTIONS

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Abstract:

- The choice and design of loss functions is discussed. Particularly when computational methods like cross-validation are applied, there is no need to stick to “standard” loss functions such as the  $L_2$ -loss (squared loss). Our main message is that the choice of a loss function in a practical situation is the translation of an informal aim or interest that a researcher may have into the formal language of mathematics. The choice of a loss function cannot be formalized as a solution of a mathematical decision problem in itself. An illustrative case study about the location of branches of a chain of restaurants is given. Statistical aspects of loss functions are treated, such as the distinction between applications of loss functions to prediction and estimation problems and the direct definition of estimators to minimize loss functions. The impact of subjective decisions to the design of loss functions is also emphasized and discussed.

Key-Words:

- *prediction; estimation; decision theory; M-estimator; MM-estimator; linear regression.*

AMS Subject Classification:

- 62A01, 62C05, 62G09, 62J05, 62M20.



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## 1. INTRODUCTION

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Most statistical problems are defined in terms of loss functions in the sense that loss functions define what a “good” estimator or a “good” prediction is. This paper discusses some aspects of the choice of a loss function. The main message of the paper is that the task of choosing a loss function is about the translation of an informal aim or interest that a researcher may have in the given application into the formal language of mathematics. The choice of a loss function cannot be formalized as a solution of a mathematical decision problem in itself, because such a decision problem would require the specification of another loss function. Therefore, the choice of a loss function requires informal decisions, which necessarily have to be subjective, or at least contain subjective elements. This seems to be acknowledged somewhat implicitly in the decision theoretic literature, but we are not aware of any sources where this is discussed in detail.

Several different uses of loss functions can be distinguished.

- (a) In *prediction problems*, a loss function depending on predicted and observed value defines the quality of a prediction.
- (b) In *estimation problems*, a loss function depending on the true parameter and the estimated value defines the quality of estimation. As opposed to prediction problems, this assumes a statistical model to hold, which defines the parameter to be estimated. The true parameter value in an estimation problem is generally unobservable, while in a prediction problem the “truth” is observable in the future.
- (c) *Definition of estimators*: many estimators (such as least squares or M-estimators) are defined as optimizers of certain loss functions which then depend on the data and the estimated value. Note that this is essentially different from (a) and (b) in the sense that the least squares estimator is not necessarily the estimator minimizing the mean squared estimation error or the squared prediction error.

There are several further uses of loss functions, which won’t be treated in the present paper, for instance defining optimal testing procedures, Bayesian risk, etc.

While general loss functions have been treated in the literature<sup>1</sup>, versions of the squared loss function are used in a vast majority of applications of prediction and estimation problems (note that UMVU estimation is a restricted optimization of a squared loss function). Main reasons for this seem to be the simplicity of the mathematics of squared loss and the self-confirming nature of the frequent

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<sup>1</sup>See, for instance, Lehmann and Casella ([6]), who mainly use squared loss, but discuss alternatives in several chapters.

use of certain “standard” methods in science. However, if prediction methods are compared using nonparametric resampling techniques such as cross-validation and bootstrap, there is no computational reason to stick to the squared loss, and other loss functions can be used. Robustness aspects of loss functions have been discussed previously by Ronchetti, Field and Blanchard ([9]) and Leung ([7]).

In Section 2, the subject-matter dependent design of a loss function in a business application using robust regression is discussed to give an illustrating example of the “translation problem” mentioned above and to motivate some of the discussion in the following sections.

In Section 3, the implications of the different statistical uses of loss functions (a), (b) and (c) above are explored in more detail. The question whether the negative loglikelihood can be considered as the “true” objective loss function in estimation is discussed.

In Section 4, some philosophical aspects are treated. In particular, the concepts of subjectivity and objectivity, emphasizing the role of subjective decisions in the choice of loss functions, and the standardizing role of communication in the scientific community are discussed. Finally, a brief conclusion is given.

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## **2. LOCATIONS OF RESTAURANTS: A CASE STUDY**

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The case study presented in this section is about a prediction problem in a business application. Because the original study is confidential, the story presented here is made up, and the original data are not shown. The values and rankings in Tables 1 and 2, however, are authentic (absolute and squared losses have been multiplied by a constant).

A restaurant chain wanted to predict the turnover for new branches, depending on the following six independent variables:

- number of people living in a (suitably defined) neighborhood,
- number of people working or shopping at daytime in the neighborhood,
- number of branches of competitors in the neighborhood,
- size of the branch,
- a wealth indicator of the neighborhood,
- distance to the next branch of the same chain.

The results are to be used to support decisions such as where to open new branches, and what amount of rents or building prices can be accepted for particular locations. Data from 154 already existing branches on all the variables

were available. In our study we confined ourselves to finding a good linear regression type prediction rule, partly because the company wanted to have a simple formula, and partly because an alternative (regression trees) had already been explored in a former project.

The data are neither apparently nonlinear, nor heteroscedastic in any clear systematic way. However, there are obvious outliers. We decided to choose the best out of several more or less robust linear regression estimators using leave-one-out cross-validation (LOO-CV). In the real study, choice of transformations of variables and variable selection have also been considered, but this doesn't add to the discussion of interest here.

Note that LOO-CV processes all data points in the same manner, which means that all observations are treated as if they were a representative sample from the underlying population of interest. Particularly, outliers are treated in the same way as seemingly more typical data points (but may be weighted down implicitly, see below). This makes sense if there is no further subject matter information indicating that the outliers are erroneous or atypical in a way that we would not expect similar observations anymore in the future. In the given case study, outlying observations are not erroneous and stem from restaurants at some locations with special features. It may well be possible that further outliers occur in the future for similar reasons.

The estimators we took into account were

- the least squares (LS)-estimator,
- the least median of squares (LMS)-estimator as suggested by Rousseeuw ([10]),
- Huber's M-estimator for linear regression with tuning constant  $k=1.345$  to produce 95% efficiency for normal samples, see Huber ([5]),
- an M-estimator for linear regression using the "bisquared" objective function with tuning constant  $k=4.685$  to produce 95% efficiency for normal samples, see Western ([13]),
- the MM-estimator suggested by Yohai ([14]) tuned to 95% efficiency for normal samples.

In principle, it is reasonable to include M-/MM-estimators tuned to smaller efficiency as well, which will then potentially downweight some further outliers. However, we compared several tunings of the MM-estimator in one particular situation, from which we concluded that not too much gain is to be expected from smaller tunings than 95% efficiency (larger efficiencies can be better, but our results on this are quite unstable).

All estimators were used as implemented in R ([www.R-project.org](http://www.R-project.org)), but the implementations we used for this project have been replaced by new ones

in the meantime (in packages “MASS” and “robustbase”). The scale estimator used for the two M-estimators was a re-scaled median absolute deviance (MAD) based on the residuals (as implemented in the function `r1m`).

The estimators have been compared according to the estimated expected prediction error

$$(2.1) \quad \frac{1}{n} \sum_{i=1}^n L(y_i, \hat{y}_{-i}),$$

where  $n$  is the number of observations,  $y_1, \dots, y_n$  are the observed turnovers, and  $\hat{y}_{-i}$  is the predicted value of the turnover for  $y_i$  from applying the linear regression method to the data omitting the  $i^{\text{th}}$  observation.  $L$  is a loss function, of which the design will be discussed in the following.

Note that (2.1) already implies some decisions. Firstly,  $L$  is defined here to depend on  $y_i$  and  $y_{-i}$  only, but not directly on the values of the independent variables of the  $i^{\text{th}}$  observation. In general, this restriction is not required, but it is justified in the present setup by the fact that the company didn’t specify any particular dependence of their tolerance of prediction errors on the values of the independent variables, and there is no obvious subject-matter reason in the present study for such a dependence to be needed. This is a first illustration of our major principle to translate the informal interests and aims of those who use the results in the formal mathematical language.

Secondly, it is part of the design of the loss function not just to choose  $L$ , but also to decide about how the values of  $L(y_i, \hat{y}_{-i})$  should be aggregated. Their mean is used in (2.1), but instead, their maximum, their median, another quantile or a trimmed mean could be chosen as well. Note that there is some interaction between the choice of  $L$  and the choice of how the values of  $L$  are to be aggregated. For example, under the assumption that we would like to do something robust against outliers, the choice of a bounded  $L$ -function bounds the influence of extreme prediction errors in itself and allows therefore the aggregation of the  $L$ -values in a less robust manner such as taking their mean. For the present study, we confine ourselves to the mean, of which the interpretation is that the prediction error of every single observation is judged as equally important to us, and we will deal with the influence of extreme observations via the choice of  $L$ .

As mentioned before, the “standard” loss function for this kind of problem is defined by  $L_2(y, \hat{y}) = (y - \hat{y})^2$ , but because we use LOO-CV, there is no mathematical reason to use  $L = L_2$ .

One of the decisions to make is whether  $L$  should be symmetric. This means that a negative prediction error is judged as causing the same loss as a positive error of the same absolute value. This is difficult to judge in the present situation.

It could be argued that it is not as bad for the company to underestimate the turnover at a particular location than to overestimate it, because the money spent by the company on a branch with overestimated turnover may be lost.

However, because the prediction should guide the decision whether a branch should be opened in the first place, how much rent should be paid and also how the branch will be initially equipped, underestimation of the turnover may have serious consequences as well, as offers for good locations may be turned down or under-equipped. Though the effects of over- and underestimation can be considered to be asymmetric in the present setup, we decided to stick to symmetric loss functions, meaning that the loss of paid money is treated as equally bad as the loss of money which is not earned because of a missed opportunity.

A main feature of  $L_2$  is its convexity, which means that the differences between high prediction errors are assessed as more important than differences between small prediction errors. As an example, consider two prediction rules that only differ with respect to their cross-validated predictions of two data points,  $y_1$  and  $y_2$ . Suppose that for rule 1,  $y_1 - \hat{y}_{-1} = 10,000$ ,  $y_2 - \hat{y}_{-2} = -10$ , and for rule 2,  $y_1 - \hat{y}_{-1} = 9,990$ ,  $y_2 - \hat{y}_{-2} = -20$  (the units of  $y$  don't have a particular meaning here because we have to use artificial values anyway, but you may imagine them to mean £ 1,000 a year).  $L_2$  favours rule 2 in this situation. But is this adequate?

Going back to the discussion above, if the values could be interpreted as earned (or lost) money, the  $L_1$ -loss ( $L_1(y, \bar{y}) = |y - \bar{y}|$ ) seemed to be more adequate, because it assesses both rules as equally good, based on the fact that they both cause the same direct or indirect financial loss of 10,010 units. For the restaurant case, switching from  $L_2$  to  $L_1$ -loss makes a big difference in terms of the quality ranking of the methods, as can be seen in Table 1.

**Table 1:** Ranking of regression methods and loss function values (multiplied by two different constants, for  $L_1$  and  $L_2$ ); the higher the rank, the better the result in terms of (2.1), using  $L = L_2$  and  $L = L_1$ , evaluated on the restaurant data.

| $L_2$         |      | $L_1$         |      |
|---------------|------|---------------|------|
| 1. M-Huber    | 3203 | 1. MM         | 2205 |
| 2. LS         | 3235 | 2. M-Huber    | 2219 |
| 3. MM         | 3524 | 3. M-Bisquare | 2247 |
| 4. M-Bisquare | 3651 | 4. LS         | 2274 |
| 5. LMS        | 3692 | 5. LMS        | 2278 |

However, the situation is more complex. Firstly, the data made available to us are about turnover and not about profit (a reason for this may be that for the accurate prediction of profits factors carry a higher weight that rather

have to do with management decisions than with the location of the branch). Usually, profits are less sensitive against differences between two large values of turnovers than against the same absolute differences between two smaller values of turnovers. Therefore, more tolerance is allowed in the prediction of larger  $y_i$ -values.

Secondly, the data give turnovers over a long period (three years, say), and after a new branch has been opened, if it turns out after some months that the turnover has been hugely wrongly predicted, the management has several possibilities of reaction, ranging from hiring or firing staff over special offers and campaigns attracting more customers to closing the branch.

Therefore, if predictions are hugely wrong, it matters *that* they are hugely wrong, but it doesn't matter too much *how* wrong they exactly are. This means that, at least for large absolute errors, the loss function should be concave if not constant. Actually we chose a function which is constant for large absolute errors, because we could give the lowest absolute error above which the loss function is constant a simple interpretation: above this error value, predictions are treated as "essentially useless" and it doesn't matter how wrong they precisely are. This interpretation could be communicated to the company, and the company was then able to specify this limiting value. The design of a concave but strictly increasing function would have involved much more complicated communication.

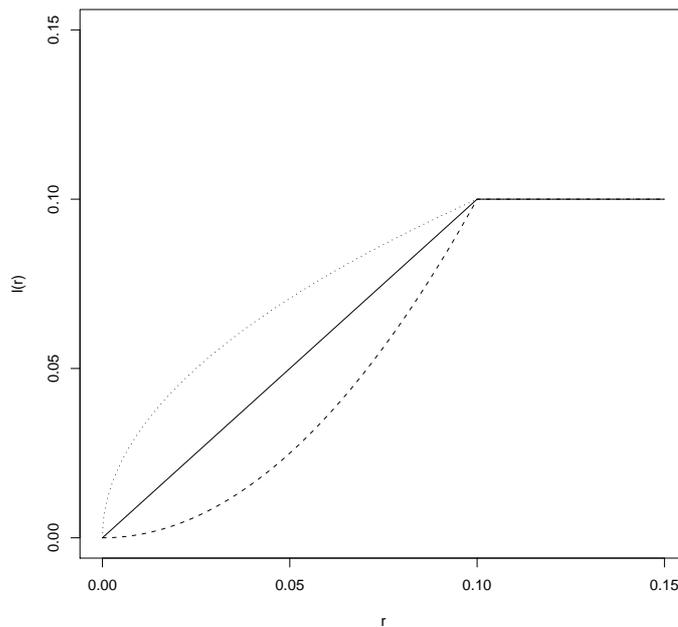
The company initially specified the critical value for "usefulness" as 10% of the true turnover, i.e., they were concerned about relative rather than absolute error, which motivated the following loss function:

$$L_c(y, \hat{y}) = \begin{cases} \frac{(y - \hat{y})^2}{y^2} & : \frac{(y - \hat{y})^2}{y^2} \leq c^2 \\ c^2 & : \frac{(y - \hat{y})^2}{y^2} > c^2, \end{cases}$$

$c = 0.1$ . Below the cutoff value  $c$ , we have used a squared function of the relative error. Two intuitive alternatives would be to choose the  $L_1$ -norm of the relative error below  $c$  or a concave function, possibly the square root, see Figure 1. Of course, an infinite number of other convex or concave functions could be chosen, but for pragmatic reasons it is necessary to discuss just a small number of possible choices, between which the differences can be given a clear interpretation.

The interpretation of  $L_1$  here is again that all differences between relative errors are treated as equally important, be they between relatively large or relatively small errors. The concave function considers differences between small errors as more important. To optimize this function, it would be advantageous to predict some (maybe very few) observations very well, while the precise relative error values for all observations causing a bit larger prediction don't matter too much. Optimizing the convex square function, on the other hand, means to try as much as possible observations to achieve a relative prediction error below  $c$ ,

while differences between small errors don't have a large influence. Because the company is interested in useful information about many branches, rather than to predict few branches very precisely, we chose the squared function below  $c$ .



**Figure 1:** Bounded functions of the relative prediction error  $r$ , the lower part being squared,  $L_1$  and square root.

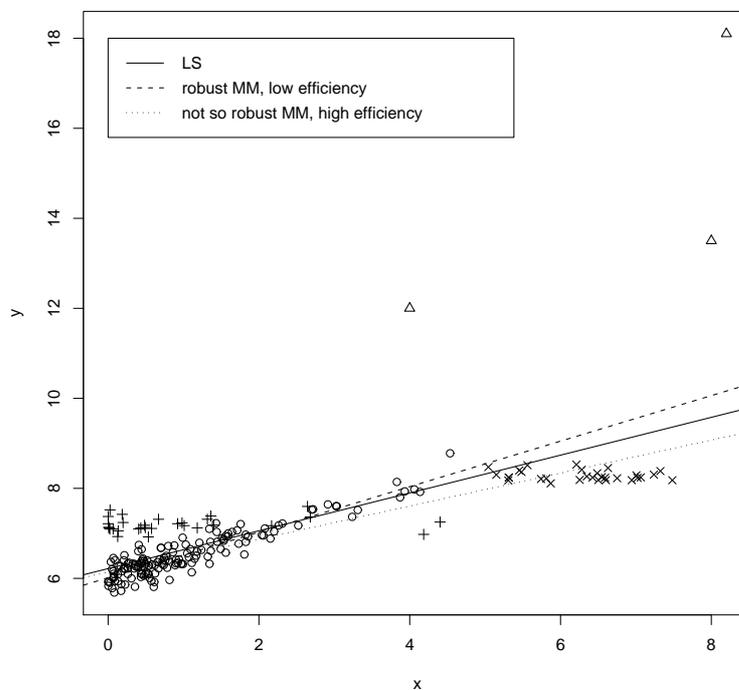
Unfortunately, when we carried out the comparison, it turned out that the company had been quite optimistic about the possible quality of prediction. Table 2 (left side) shows the ranking of the estimators, but also the number of observations of which the relative prediction error has been smaller than  $c$ , i.e., for which the prediction has not been classified as “essentially useless”.

**Table 2:** Ranking and loss function values of regression methods in terms of (2.1), using  $L = L_c$  with  $c = 0.1$  and  $c = 0.2$ . The number of observations of which the prediction has not been classified as “essentially useless” is also given.

| Ranking<br>$c = 0.1$ | # obs.<br>$\frac{(y-\hat{y})^2}{y^2} \leq 0.1^2$ | $10^7*$<br>$L_{0.1}$ | Ranking<br>$c = 0.2$ | # obs.<br>$\frac{(y-\hat{y})^2}{y^2} \leq 0.2^2$ | $10^6*$<br>$L_{0.2}$ |
|----------------------|--|----------------------|----------------------|--|----------------------|
| 1. M-Huber           | 42   | 8117                 | 1. MM                | 85   | 2474                 |
| 2. M-Bisquare        | 49   | 8184                 | 2. M-Bisquare        | 86   | 2482                 |
| 3. LS                | 38   | 8184                 | 3. M-Huber           | 83   | 2494                 |
| 4. MM                | 49   | 8195                 | 4. LMS               | 75   | 2593                 |
| 5. LMS               | 39   | 8373                 | 5. LS                | 81   | 2602                 |

With  $n = 154$ , this is less than a third of the observations for all methods. Confronted with this, the company decided to allow relative prediction errors up to 20% to be called “useful”, which at least made it possible to obtain reasonable predictions for more than half of the observations. The company accepted this result (which can be seen on the right side of Table 2) though we believe that accepting even larger relative errors for more branches as “useful” would be reasonable, given the precision of the data at hand. One could also think about using a squared function of the relative error below  $c = 0.2$ , constant loss above  $c = 0.4$  and something concave in between, which, however, would have been difficult to negotiate with the company. The question whether it would be advantageous to use an estimator that directly minimizes  $\sum L(y, \hat{y})$ , given a loss function  $L$ , instead of comparing other estimators in terms of  $L$  is treated in Section 3.1.

The considered loss functions lead to quite different rankings of methods. Figure 2 gives an illustration how the choice of the loss function affects the optimality of the estimator. It shows artificially generated heterogeneous data, coming from four different groups, all generated by normal errors along some regression line. The groups are indicated by four different symbols: circles (150 points), pluses (30 points), crosses (30 points) and triangles (3 points).



**Figure 2:** Artificial heterogeneous data with fits of three different regression estimators, giving full weight to all data (LS), only the majority group (circles; low efficiency MM) and about 80% of the data (high efficiency MM).

The plot has a rough similarity with some of the scatterplots from the original restaurants data. If the aim is to fit some points very well, and the loss function is chosen accordingly, the most robust “low efficiency MM-estimator” in Figure 2 is the method of choice, which does the best job for the majority of the data. A squared loss function would emphasize to make the prediction errors for the outlying points (triangles) as small as possible, which would presumably favour the LS-estimator here (this is not always the case, see Section 3). However, if the aim is to yield a good relative prediction error for more data than fitted well by the robust estimator, the less robust, but more efficient MM-estimator (or an estimator with breakdown point of, say, 75%) leads to a fit that does a reasonable job for circles, crosses, and some of the pluses. The decision about the best approach here is depending on the application. For instance, an insurance company may be interested particularly in large outliers and will choose a different loss function from a company which considers large prediction errors as “essentially useless”. But even such a company may not be satisfied by getting only a tight majority of the points about right.

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### 3. STATISTICAL ASPECTS

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Though Section 2 was about prediction, methods have been compared that were originally introduced as parameter estimators for certain models, and that are defined via optimizing some objective (loss) functions. Therefore the applications (a), (b) and (c) of loss functions mentioned in the introduction were involved. Here are some remarks about differences and relations between these uses.

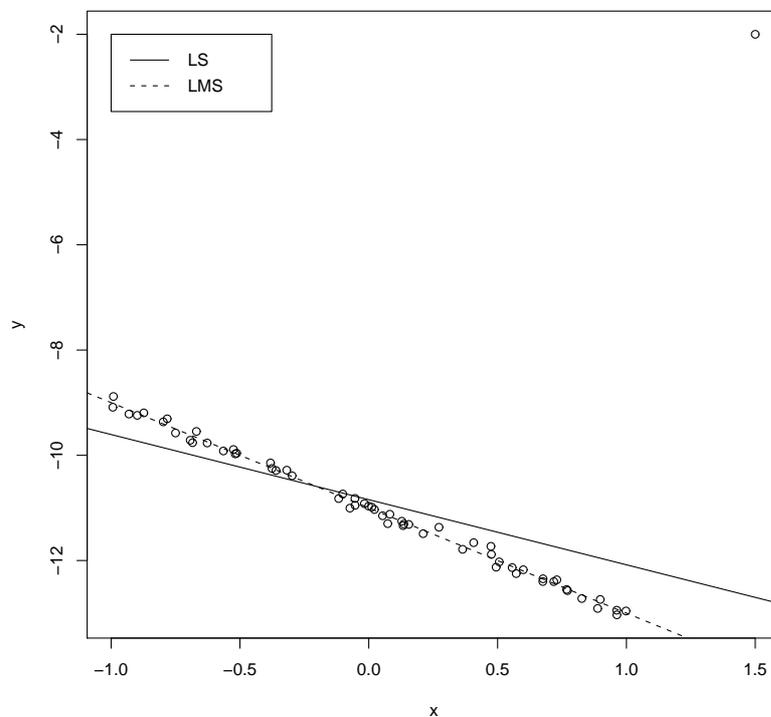
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#### 3.1. Prediction loss vs. objective functions defining estimators

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First of all, the estimator defined by minimizing  $\sum L(y, \hat{y})$  is not always the best predictor in terms of  $\sum L(y, \hat{y}_{-i})$ . Consider the situation in Figure 3, given that  $L = L_2$ , the squared loss function. Compare the LS-estimator with a robust estimator giving zero weight to the outlier at  $(1.5, -2)$ , the LMS-estimator, say, using LOO-CV. Whenever a non-outlier is deleted, the LMS-estimator computed from the remaining points will give an almost perfect fit, while the LS-estimator will be strongly influenced by the outlier. This means that the LMS estimator will be much better in terms of  $L_2(y, \hat{y}_{-i})$ . If the outlier is left out, LMS- and LS-estimator will get about the same line, which gives a bad prediction for the outlier. Adding the loss values up, the LMS-estimator gives a much smaller estimated  $L_2$ -prediction error. This is not mainly due to the use of LOO-CV, but will happen with any resampling scheme which is based on the prediction of

a subsample of points by use of the remaining points. The situation changes (for LOO-CV) when further outliers are added at about  $(-1.5, 2)$ . In this case, the LS-estimator is better in terms of the estimated  $L_2$ -prediction error, because this is dominated by the outliers, and if one outlier is left out, the further outliers at about the same place enable LS to do a better job on these than the robust estimator. The situation is again different when outliers are added at other locations in a way that none of the outliers provides useful information to predict the others. In this situation, it depends strongly on where exactly the outliers are whether LOO-CV prefers LS or LMS. Here, the assessment of the prediction error itself is non-robust and quite sensitive to small changes in the data.



**Figure 3:** Artificial data with fits of LS and LMS estimator.

From a theoretical point of view, apart from the particular use of LOO-CV to estimate the prediction error, LS is clearly better than LMS in terms of  $L_2$ -prediction loss, in a “normal model plus outliers” situation, if the outliers make it possible to find a suitable compromise between fitting them and the majority, while it is bad for LS if the outliers are scattered all over the place and one outlier doesn’t give useful information about the prediction of the others (as for example in a linear model with Cauchy random term). Whether the  $L_2$ -loss is reasonable or the LMS-fit should be preferred because it predicts the “good” majority of the data better even in cases where the outliers can be used to predict each other depends on subject-matter decisions.

Asymptotically, using empirical process theory, it is often possible to show that the estimator defined by minimizing  $\sum L(y, \hat{y})$  is consistent for  $\theta$  minimizing  $EL(y, \theta)$  (in such situations, optimal prediction optimizing  $L$  and estimation of  $\theta$  are equivalent). Therefore, for a given loss function, it makes at least some sense to use the estimator defined by the same objective function. However, this is often not optimal, not even asymptotically, as will be shown in the next section.

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### 3.2. Prediction and maximum likelihood-estimation

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Suppose that the data have been generated by some parametric model. Then there are two different approaches to prediction:

1. find a good prediction method directly, or
2. estimate the true model first, as well as possible, solve the prediction problem theoretically on the model and then plug in the estimated parameter into the theoretical prediction rule.

As an example, consider i.i.d. samples from an exponential( $\lambda$ )-distribution, and consider prediction optimizing  $L_1$ -loss. The sample median suggests itself as a prediction rule, minimizing  $\sum L_1(y - \hat{y})$ . The theoretical median (and therefore the asymptotically optimal prediction rule) of the exponential( $\lambda$ )-distribution is  $\log 2/\lambda$ , and this can be estimated by maximum likelihood as  $\log 2/\bar{X}_n$ ,  $\bar{X}_n$  being the arithmetic mean. We have simulated 10,000 samples with  $n = 20$  observations from an exponential(1)-distribution. The MSE of the sample median has been 0.566 and the MSE of the ML-median has been 0.559. This doesn't seem to be a big difference, but using the paired Mann-Whitney test (not assuming a particular loss function), the advantage of the ML-median is highly significant with  $p < 10^{-5}$ , and the ML-median was better than the sample median in 6,098 out of 10,000 simulations.

Therefore, in this situation, it is advantageous to estimate the underlying model first, and to derive predictions from the estimator. There is an asymptotic justification for this, called the "convolution theorem" (see, e.g., Bickel et al, [1], p.24). A corollary of it says that under several assumptions

$$(3.1) \quad \liminf_{n \rightarrow \infty} E_{\theta} L\left(\sqrt{n}(T_n - q(\theta))\right) \geq E_{\theta} L\left(M_n - q(\theta)\right),$$

where  $q(\theta)$  is the parameter to be estimated (which determines the asymptotically optimal prediction rule),  $T_n$  is an estimator and  $M_n$  is the ML-estimator. This holds for every loss function  $L$  which is a function of the difference between estimated and true parameter satisfying

$$(3.2) \quad L(x) = L(-x), \quad \left\{x: L(x) \leq c\right\} \text{ convex } \forall c > 0.$$

(3.2) is somewhat restrictive, but not strongly so. For example, it includes all loss functions discussed in Section 2 (applied to the estimation problem of the optimal prediction rule instead of direct prediction, however).

This fact may provoke three misinterpretations:

1. estimation is essentially equivalent to prediction (at least asymptotically — though the exponential example shows that the implications may already hold for small  $n$ ),
2. the negative loglikelihood can be seen as the “true” loss function belonging to a particular model. In this sense the choice of the loss function would rather be guided by knowledge about the underlying truth than by subjective subject-matter dependent decisions as illustrated in Section 2,
3. all loss functions fulfilling (3.2) are asymptotically equivalent.

Our view is different.

1. The main assumption behind the convolution theorem is that we know the true parametric model, which is obviously not true in practice. While the ML-median performed better in our simulation, prediction by  $\log 2/\bar{X}_n$  can be quite bad in terms of  $L_1$ -loss if the true distribution is not the exponential. The sample median can be expected to perform well over a wide range of distributions (which can be backed up by asymptotic theory, see above), and other prediction rules can turn out to be even better in some situations using LOO-CV and the like, for which we don’t need any parametric assumption.

The basic difference between prediction and estimation is that the truth is observable in prediction problems, while it is not in estimation problems. In reality, it can not even be assumed that any probability model involving an i.i.d. component holds. In such a case, estimation problems are not well defined, while prediction problems are, and there are prediction methods that are not based on any such model. Such methods can be assessed by resampling methods as well (though LOO-CV admittedly makes the implicit assumption that the data are exchangeable).

Apart from this, there are parametric situations, in which the assumptions of the convolution theorem are not satisfied and optimal estimation and optimal prediction are even asymptotically different. For example, in many model selection problems, the BIC estimates the order of a model consistently, as opposed to the AIC (Nishii [8]). But often, the AIC can be proved to be asymptotically better for prediction, because for this task underestimation of the model order matters more than overestimation (Shibata [11], [12]).

2. The idea that the negative loglikelihood can be seen as the “true” loss function belonging to a particular model (with which we have been confronted in private communication) is a confusion of the different applications of loss functions. The negative loglikelihood *defines* the ML estimator, which is, according to the convolution theorem, asymptotically optimal with respect to several loss functions *specifying an estimation problem*. These loss functions are assumed to be symmetric. In some applications asymmetric loss functions may be justified, for which different estimators may be optimal (for example shrunk or inflated ML-estimators; this would be the case in Section 2 if the company had a rather conservative attitude, were less keen on risking money by opening new branches and would rather miss opportunities as long as they are not obviously excellent). This may particularly hold under asymmetric distributions, for which not even the negative loglikelihood itself is symmetric. (The idea of basing the loss function on the underlying distribution, however, could make some sense, see Section 3.4.)

In the above mentioned simulation with the exponential distribution, LOO-CV with the  $L_1$ -loss function decided in 6,617 out of 10,000 cases that the ML-median is a better predictor than the sample median. This shows that in a situation where the negative loglikelihood is a good loss function to *define* a predictor, LOO-CV based on the loss function in which we are really interested is able to tell us quite reliably that ML is better than the predictor based on direct optimization of this loss function (which is the sample median for  $L_1$ ).

3. The idea that all loss functions are asymptotically equivalent again only applies to an estimation problem of a given parameter assuming that the model is known. The convolution theorem doesn’t tell us in which parameter  $q(\theta)$  in (3.1) we should be interested. The  $L_1$ -loss for the prediction problem determines that it is the median.

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### 3.3. Various interpretations of loss functions

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According to our main hypothesis, the choice of a loss function is a translation problem. An informal judgment of a situation has to be translated into a mathematical formula. To do this, it is essential to keep in mind how loss functions are to be interpreted. This depends essentially on the use of the loss function, referring to (a), (b) and (c) in the introduction.

- (a) In prediction problems, the loss function is about how we measure the quality of a predicted value, having in mind that a true value exists and will be observable in the future. As can be seen from the restau-

rant example, this is not necessarily true, because if a prediction turns out to be very bad early, the company will react, which prevents the “true value” under the prediction model from being observed (it may further happen that the very fact that the company selects locations based on a new prediction method changes the underlying distribution). However, the idea of an observable true value to be predicted, enables a very direct interpretation of the loss function in terms of observable quantities.

- (b) The situation is different in estimation problems, where the loss function is a function of an estimator and an underlying, essentially unobservable quantity. The quantification of loss is more abstract in such a situation. For example, the argument used in Section 2 to justify the boundedness of the loss function was that if the prediction is so wrong that it is essentially useless, it doesn’t matter anymore how wrong it exactly is. Now imagine the estimation of a treatment effect in medicine. It may be that after some study to estimate the treatment effect, the treatment is applied regularly to patients with a particular disease. Even though, in terms of the prediction of the effect of the treatment on one particular patient, it may hold that it doesn’t matter how wrong a grossly wrong prediction exactly is, the situation for the estimation of the overall effect may be much different. Under- or overestimation of the general treatment effect matters to quite a lot of patients, and it may be of vital importance to keep the estimation error as small as possible in case of a not very good estimation, while small estimation errors could easily be tolerated. In such a case, something like the  $L_2$ -loss could be adequate for estimation, while a concave loss is preferred for pointwise prediction. It could be argued that, at least in some situations, the estimation loss is nothing else than an accumulated prediction loss. This idea may justify the choice of the mean (which is sensitive to large values) to summarize more robust pointwise prediction losses, as in (2.1). Note that the convolution theorem compares *expected values* of losses, and the expectation as a functional is in itself connected to the  $L_2$ -loss. Of course, all of this depends strongly on the subject matter.
- (c) There is also a direct interpretation that can be given to the use of loss functions to define methods. This is about measuring the quality of data summary by the method. For example, the  $L_2$ -loss function defining the least squares estimator defines how the locations of the already observed data points are summarized by the regression line. Because  $L_2$  is convex, it is emphasized that points far away from a bulk of the data are fitted relatively well, to the price that most points are not fitted as precisely as would be possible. Again, a decision has to be made whether this is desired.

As a practical example, consider a clustering problem where a company wants to assign  $k$  storerooms in order to deliver goods to  $n$  shops so that the total delivery distance is minimized. This is an  $L_1$ -optimization problem (leading to  $k$ -medoids) where neither prediction nor estimation are involved. Estimation, prediction and robustness theory could be derived for the resulting clustering method, but they are irrelevant for the problem at hand.

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### 3.4. Data dependent choice of loss functions

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In the restaurant example, the loss function has been adjusted because, having seen the results based on the initial specification of  $c$ , the company realized that a more “tolerant” specification would be more useful.

Other choices of the loss function dependent on the data or the underlying model (about which the strongest information usually comes from the data) are imaginable, e.g., asymmetric loss for skew distributions and weighting schemes depending on random variations where they are heteroscedastic.

In terms of statistical theory, the consequences of data dependent changes of loss functions can be expected to be at least as serious as data dependent choices of models and methods, which may lead to biased confidence intervals, incoherent Bayesian methodology and the like. Furthermore, the consequences of changing the loss function dependent on the data cannot be analyzed by the same methodology as the consequences of the data dependent choice of models, because the latter analysis always assumes a true model to hold, but there is no single true loss function. It may be argued, though, that the company representatives have a “true subjective” loss function in mind, which they failed to communicate initially.

However, as with all subjective decisions, we have to acknowledge that people change their point of view and their assessment of situations when new information comes in, and they do this often in ways which can’t be formally predicted in the very beginning (unforeseen prior-data conflicts in Bayesian analysis are an analogous problem).

Here, we just emphasize that data dependent choice of the loss function may lead to some problems which are not fully understood at the moment. In situations such as the restaurant example, we are willing to accept these problems if the impression exists that the results from the initial choice of the loss function are clearly unsatisfactory, but loss functions should not be changed without urgency.

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#### 4. PHILOSOPHICAL ASPECTS

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The term “subjective” has been used several times in the present paper. In science, there are usually some reservations against subjective decisions, because of the widespread view that objectivity is a main aim of science.

We use “subjectivity” here in a quite broad sense, meaning any kind of decision which can’t be made by the application of a formal rule of which the uniqueness can be justified by rational arguments. “Subjective decisions” in this sense should take into account subject-matter knowledge, and can be agreed upon by groups of experts after thorough discussion, so that they could be called “inter-subjective” in many situations and are certainly well-founded and not “arbitrary”. However, even in such situations different groups of experts may legitimately arrive at different decisions. This is similar to the impact of subjective decisions on the choice of subjective Bayesian prior probabilities.

For example, even if there are strong arguments in a particular situation that the loss function should be convex, it is almost always impossible to find decisive arguments why it should be exactly equal to  $L_2$ . In the restaurant example it could be argued that the loss function should be differentiable (because the sharp switch at  $c$  is quite artificial) or that it should not be exactly constant above  $c$ . But there isn’t any clear information suggesting how exactly it should behave around  $c$ .

Note that the dependent variable in the restaurant example is an amount of money, which, in principle, can be seen as a clear example of a high quality ratio scale measurement. But even this feature doesn’t make the measurement of loss in any way trivial or objective, as has been discussed in Section 2. The fact that it is a non-scientific business application does also not suffice as a reason for the impact of subjective decisions in this example. The argument not to take the absolute value as loss function was that in case of very wrong predictions it may turn out that the prediction is wrong early enough so that it is still possible to react in order to keep the effective loss as small as possible. But this may apply as well in several scientific setups, e.g., in medical, technical and ecological applications. In such a situation there is generally no way to predict exactly what the loss of grossly wrong prediction will be. If it is not possible to predict a given situation reliably, it is even less possible to predict accurately the outcome of possible reactions in case that the initial prediction turns out to be grossly wrong. Furthermore, there are generally no objective rules about how to balance underestimation and overestimation in situations which are not clearly symmetric. Therefore, the need for subjective decisions about the choice of loss functions is general and applies to “objective” science as well.

As emphasized before, a loss function cannot be found as a solution of a formal optimization problem, unless another loss function is invented to define this problem. There is no objectively best loss function, because the loss function defines what “good” means.

The quest for objectivity in science together with a certain misconception of it has some undesirable consequences. Experience shows that it is much easier to get scientific work published which makes use of standard measurements such as the  $L_2$ -loss, even in situations in which it is only very weakly (if at all) justified, than to come up with a rather idiosyncratic but sensible loss function involving obviously subjective decisions about functional shapes and tuning constants. It is almost certain that referees will ask for objective justifications or at least sensitivity analyses in the latter case. We are not generally against such sensitivity analyses, but if they are demanded in a situation where authors come up with an already well thought over choice of a loss function, it would be much more urgent to carry out such analyses if “standard” choices have been made without much reflection.

It seems that many scientists see “general agreement” as a main source of objectivity, and therefore they have no doubts about it in case that somebody does “what everybody else does” without justification, while obviously personal decisions, even if discussed properly, are taken as a reason for suspicion. This is clearly counterproductive.

It is important to acknowledge that there is some reason for this general attitude. By changing the loss function, it may actually be possible to arrive at very different results, including results previously desired by the researcher. This is made more difficult by insisting on the use of widespread standard measures that have proven useful under a range of different situations.

We see this as a legitimate, but in no way decisive argument. Science is essentially about reaching stable rational agreement. Certainly, agreement based on the unreflected choice of standard methods cannot be expected to be stable, and it may be controversial at best whether it can be seen as rational. On the other hand, more subjective decisions will not enable agreement as long as they are not backed up by clear comprehensible arguments. Therefore, such arguments have to be given. If for some decisions, there are no strong arguments, it makes sense to stick to standard choices. Therefore, if there are strong arguments that a loss function should be convex, but there is no further clear information how exactly it should look like, the standard choice  $L_2$  should be chosen on grounds of general acceptance. But even if  $L_2$  is chosen in such a situation, convexity should still be justified and it makes even sense to admit that, apart from convexity,  $L_2$  has been chosen purely for the above reason. This is as well a subjective, but rational decision in the sense given in the beginning of this section.

A more sophisticated but often impractical approach would start from a list of characteristics (axioms) that the loss function in a particular application should fulfill, and then investigate the range of results obtained by the whole class of such loss functions.

The perhaps most important aspect of scientific agreement is the possibility to communicate in an unambiguous way, which is mainly ensured by mathematical formalism. Therefore, the subjective design of more or less idiosyncratic loss functions, including their detailed discussion, contributes to the clarity of the viewpoint of the researcher. Her subjective decisions become transparent and are accessible to rational discussion. Making the subjective impact clear in this way actually helps scientific discussion much more than to do what everybody else does without much discussion.

We don't know whether and to what extent our attitude to science is already present in the philosophical literature, but it seems to be quite close to what Ernest ([2]) wrote in his chapter about "the social construction of objective knowledge". Some more elaboration can be found in Hennig ([3]).

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## **5. CONCLUSION**

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We hope that the present paper encourages researchers to choose or design loss functions which reflect closely their expert's view of the situation in which the loss function is needed. Instead of being "less objective", this would be rather quite helpful for scientific discussion.

Robustness is not treated as an aim in itself here, but rather as an implicit consequence of the decision of the researchers about the formalization of the prediction loss for atypical observations.

There are other problems in data analysis where similar principles can be applied. One example is the design of dissimilarity measures, see Hennig and Hausdorf ([4]). Combination of different loss criteria (such as efficiency and robustness in estimation) has not been treated in the present paper, but could be approached in a similar spirit.

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