Chapter One

MANAGING RISK AND THE INVESTMENT PROCESS

1. Introduction

This chapter deals with the concept of investment process. Lack of investment process is the main reason why investors lost fortunes after 2000. They bought because the markets were going up and they were making 20-30% a year. They did not protect their capital because they did not see what was happening. In particular, they had no system, or investment process, to answer the questions:

- When to buy or sell,
- What to buy or sell,
- How much to buy or sell,
- And why to buy or sell.

The investment process is a mental framework. The framework recognizes the implications of professional money management. One of the main objectives in portfolio management is to recognize the meaning and sources of risk. Investors must set realistic objectives to make money. The issue of not losing money seems obvious. Sadly, defensive investing is not well understood by the average investor. This chapter discusses the need for an investment strategy to hedge against uncertain outlooks.

For an in-depth discussion on the relationships between financial markets and business cycles, please read my book on *Profiting in Bull or Bear Markets.*

2. The Need For An Investment Process

Successful investors practice a disciplined investment process. Professionals have a detailed step-by-step approach to structure their portfolio management. Individual investors need to learn the tools used by professionals if they want to make money. Learn to discipline yourself. If you do not know what, when, why, and how to change positions, you cannot be a successful investor. Reacting to current events without a game plan is bound to end in financial disappointment. We are not talking about play money; we are talking about all of your money. The investment process manages all your assets.

A common mistake of a novice investor is to imagine they know how to succeed because of previous accomplishments. Frequently, accomplished business people think they can invest with the same high degree of success. Within a business environment, the challenge is to develop a product or service, organize an enterprise, hire people to produce, market and sell a product or service. Many successful business people think investing money using financial assets is very similar. More often than not successful entrepreneurs are not good portfolio managers. Investing capital in the financial markets requires very special skills.

Investors should be very humble about their knowledge of investing. The second half of the 1990s gave a false impression that success was easy because of the exceptional returns of the stock market. Many people, however, lost fortunes during the debacle that took place after 2000.

Investing in the financial markets is a game you play against very astute professionals. Notice the large number of people on the other side of the table who want your money. They know the rules of the game better than you. When you invest, know the rules of the game! The winner has the most chips at the end of the game.

This book explains the rules of the game based on my experiences of managing four billion dollars in currencies, interest rates, and various other assets. Please, for your benefit, use an investment process with a structured set of tools to invest your hard earned money. Our tools tell us what, when, why, and how much to sell or buy. They help us determine what is successful; the tools are not a rigid system. They need to be flexible to fit the personality of the individual investor. Managing money is not easy. It takes time and dedication.

3. Market Risk and Investment Strategy

Any investment process must recognize the importance of risk. The best way to appreciate the concept of risk is to compare it to the idea of probability. What is the probability of making money? Or … losing money? If the probability is low, risk is high. On the other hand, if the probability of making money is high, risk is low. Investors should invest more money when risk is low because the probability of making money is high. This is the time to be aggressive. On the other hand, when the risk is high, the odds of making money are low. When the odds of making money on a specific asset are low, sell the asset. Become defensive. Raise cash if you do not know what to do. Risk shapes a good investment strategy.

As the environment changes, risk changes. In our game of investing, the other players are the investors. The board, or table, is the market. Poker players know the probability of winning changes as the game evolves. Realize the investment game is dynamic, like poker or any other game of strategy. As the game is played, the odds change. For instance, the odds of winning in team sports change depending on shifts in morale, injuries, and how the other team plays.

An in-depth knowledge of the rules of the game helps to determine the risk of the game and establish the chances of winning with a given set of strategies. Strategy improves the odds of winning. As the game changes, we continually evaluate how risk has changed and devise a new strategy. Poker offers a good analogy. Players do not bet the same amount each time. They begin with a small bet because they do not know how their hand will develop. They increase their bet only if their hand looks promising. Depending on what the other players do, they raise their bet only if the odds of winning increase. If the odds turn against them and the risk of losing becomes high, they fold their hand.

Investing your money offers similar challenges. Like it or not, we all participate in the investment game. The economy and financial markets is the table upon which the game is played. Investors continually change the risk/reward profile of each market by getting new cards, raising their bets or dropping from the game. We need to adapt our investment strategy and change the size of our bet (investment). Because risk changes during the game, we change our bet accordingly. Adapting your portfolio to the changing risk is the only tool under your control to avoid serious losses as in 2000. The major advantage in lowering the risk, thus lowering the volatility of your portfolio, is to make your returns more predictable.

When inflation rises, risk increases because the Fed shifts to a restrictive monetary policy and stocks decline. When inflation declines, the risk in the financial markets is low. Bond prices start going up, followed by a rising stock market. By looking at economic indicators (like inflation), investors can assess the direction of risk and develop their investment strategy.

How do we plan for the risk of an event like war or an act of terrorism? There is no protection against these types of events. History shows that the country with the strongest economy always wins the war. Now you know where to place your bets. In general, investors cannot protect themselves against event risk. The only protection is to adopt an investment strategy based on value and prudent investment strategies. Do not panic when a sudden crisis occurs. A portfolio based on value rises to its proper level.

Many events dramatized by the press are irrelevant in developing an investment strategy. The so-called energy shortage is one example. When the price of crude oil spikes and rises sharply, the press dramatizes the event. The comments on TV and newspapers explain the rise as due to shortages. At other times, the financial press talks about shortages in natural gas. The idea of shortages is very misleading. All commodity prices move in the same direction. This includes short-term interest rates. Short-term interest rates in effect are the price of the commodity money. If crude oil spikes, the odds favor a strong upward move in copper, aluminum, natural gas, and short-term interest rates.

If investors believe OPEC drives crude oil prices higher, they must also believe that OPEC controls copper prices, aluminum prices, or short-term interest rates. All of these prices move in the same direction. In other words, cartels (like OPEC and the Fed) do not control the price of the commodity they manage. Cartels react. For example, OPEC supposedly controls the price of crude oil, while the Fed supposedly controls the price of short-term interest rates. That is far from the truth. Cartels only create volatility in the price of the commodity. Ultimately, the market drives the price of oil. The Fed may control short-term interest rates for limited periods. Ultimately, the market decides the level of short-term interest rate (the price of money). Cartels can control prices for a very short time like they did in the early part of the 70's. However, eventually, the markets drive oil prices or interest rates sharply higher or lower.

Risk also depends on the knowledge of the investor. The successful investors recognize there is always room to learn in a field of failures. Financial markets require a specialized, in depth, diversified, flexible knowledge, and attitude. Lack of investment knowledge is highly correlated with big losses. Smart investors satisfy themselves with modest returns and protections against loss. They know that if they lose money they must work harder to regain the losses. The professional investor gears their portfolio to that outcome. The individual investor doesn't recognize this possibility.

Formula investing, indexing, averaging down, buy and hold, diversifications are all easy to understand, but they are not necessarily profitable. Beware of anything that sounds simple!

In more than 30 years in this business, I have never found a formula that predicts with certainty. At some point in time, they all eventually fail miserably causing painful losses. Indexing was in vogue in the 1990s. Investors paid dearly by following this strategy after 2000. All major stock market indexes, bloated with technology stocks, collapsed when the tech bubble exploded in 2000. Indexing proved to be disastrous for investors in that period. Only the mutual funds that touted indexing gained a benefit.

Averaging down is another formula for financial suicide. Buying Enron's stock as the company sagged into bankruptcy allowed investors to own nothing. Diversification is a concept similar to indexing. This idea says, "Buy a bit of everything to spread the risk." Unfortunately, when you buy a bit of everything, portfolios perform like the averages. When the market drops, the value of the portfolio drops.

Investment fallacies

- Formula investing
- Indexing
- Averaging down
- Buy and hold
- Over diversification

Many advisors suggest a buy-and-hold strategy to solve the problems. Like all attractive formulas, a buy-and-hold strategy has serious drawbacks. Buy-and-hold assumes stock prices will go up over the long-term. The problem is that by the time an investor has saved enough money to invest, he or she is likely to be about 50 years old. If our 50 year old investor were living in 1929, in 1968, or 2000 they would have to wait more than a decade before they could recover their lost capital and then finally make money in stocks. And yet, many advisors continue to recommend this strategy. The collapse of the market in 2000 is the latest example of a faulty strategy. Try to tell a 70 year old investor to think long-term after they lost 75% of their capital. If a person loses 75% of their capital, they have to almost triple the remaining 25% of the capital just to break even. Tripling your money is very difficult, especially in uncertain market conditions. Tripling your money takes more than one decade using average rate of returns. Thus, a 50 year old investor has to ask, "How many decades do I have to live?"

Making money is not easy. It takes work, dedication, and discipline. It takes a keen understanding of market interactions. By using tools in a disciplined manner, we can select sectors and stocks to minimize setbacks from falling prices and capitalize on the rising prices in the markets. This book explains the tools developed through many years. Are they the best ones? No! But, they served me well. They allowed me to survive the carnage of severe bear markets in the past 30 years.

4. <u>Setting Realistic Objectives</u>

In the last part of the 1990's, the stock market rolled ahead accompanied by a red-hot economy and stimulated by excess liquidity from the Federal Reserve System. This occurred at a time when Mr. Greenspan talked about 'irrational exuberance' and the Fed was injecting liquidity into the banking system at rates between 7% and 15%. The Fed's actions ignored the average growth rate in liquidity since 1955 was close to 6%.

The excessive liquidity created a booming economy and a soaring stock market. The main feature of the market in last part of the 1990's was an enormous creation of debt. The belief that 20-25% a year returns in the stock market was normal justified many accounting irregularities. At that time, day traders used computers to trade online and make thousands of dollars. Sadly, it was not their skills that made them rich, but a soaring stock market. Traders believe their profits were generated by their skills. People speculated with their retirement plans. Just throw the dart at the page of the stock market. It was impossible to make a mistake. Everything was going up.

During those times, I spoke around the country about setting realistic objectives. Many investors in the audience just smiled. The smiles of disbelief are hard to forget. My presentations focused on prudent careful investing. Why should people be prudent and careful if they can make 20-30% a year with some stocks doubling in a month? After 2000, stock prices suffered tremendous losses of 50-70%. This meant that losses could only be regained if the remaining capital would double or triple.

If investors make 15% in the 1st year; then make 15% in the 2nd year; then make 15% in the 3rd year; but for some unexpected reasons they lose 15 % in the 4th year, the return over those 4 years is slightly higher than 6%. All the efforts to make money in those 3 years are totally wiped out by just one loss of 15% in the 4th year. Look at it this way. If you lose 50% of your money, you have to make 100% to come back and break even. If the market provides 7-8% a year on average, it will take roughly 9–10 years before you break even. Thus, the paramount strategy is to protect a portfolio against price drops. Any decision to buy or sell must be geared to preserve your capital.

After 2000, investors realized some of their mistakes and the need to be prudent with their money. This issue is important. When we set realistic objectives, we fight two major emotional extremes: one is greed and one is despair. Around 2002, after a 70% decline in the market, some people felt despair. Many decided to simply forget about their investments. Further, they rationalized that investing was either not for them or they would eventually recover. Instead, the savvy investor targets the golden median between greed and despair. I call the golden median being realistic.

History shows that the long-term return of the stock market is very close to 7–9% depending on who computes it and how it is computed. This 7-9% return is very close to the average growth rate in credit expansion. It is about equal to the growth in the economy. It is very similar to the growth of earnings per share. It is very similar to the growth in stock market prices and to the growth of income. This is not a coincidence. The growth of the economy generates wealth and this wealth is distributed among the economic players. Returns above the norm should signal caution, not greed. When politicians try to convince us we are in a new economy, be especially cautious. Simply, set a return of 7-9% as a realistic objective. Keep the 7-9% return in mind, when markets soar or collapse.

Another important lesson taught from the late 1990's bubble is that when chasing unrealistic objectives, people add volatile stocks to their portfolio. When the volatile stock price rises, the excitement is satisfying. The problem is volatility causes great losses when the market declines. The high volatility of a stock adds to the volatility of a portfolio. Thus, your returns become less reliable and more difficult to manage.

The experience of 1998-2003 proves that the strong volatility on the upside was followed by the same volatility on the downside. In other words, the 20% profit was followed by 20% losses if you failed to leave the table. As a portfolio becomes more volatile, it becomes a liability. Investors must be keenly aware of when to sell. A volatile environment increases the difficulty of this decision.

Wise investors aim for steady returns. A steady return is valuable because is predictable. Achieving predictable returns is the main point of this book. This point becomes clear when we discuss the concept of predictable sectors and stock volatility in detail. After 2000, the investors who had salvaged their money gratefully realized the wisdom of managing for a predictable return.

5. Defining the Investment Process

The investment process provides a framework for making investment decisions. Thus, investors step through a series of decisions as follows:

1. Why to buy and sell,
2. What to buy or sell,
3. When to buy or sell, and
4. How much to buy or sell.

Each decision is supported by information guiding your decision toward the best course of action. As investors learn and use the disciplined steps of the investment process, managing their portfolio becomes easier.

The first step is to answer why to buy or sell a stock. Investors decide if the conditions to buy stocks are favorable. We look at the past to determine what happened at major turning points in the stock market. The same analysis can be used to see what happened at major turning points in the bond market, commodities, precious metals stocks, or other sectors. The challenge is to extract relevant information from the past and use it to decide on investments - now.

For example, how does understanding the economic environment impact our decisions on when to buy or sell? Let's assume the Fed is concerned about low inflation and the weakness of the economy. They inject considerable amounts of liquidity into the banking system and lower the inter-bank rate (fed funds) to raise inflationary expectations and strengthen the economy. If the administration is Republican, they generally propose cutting taxes. This type of political and financial environment is typically associated with a major market bottom.

The end of the 1995-2000 bubble was anticipated by rising short-term interest rates and less liquidity in the banking system. These signals were there for everybody to see. Greed, however, distorted the decision making process of most people. In those years, the economy roared ahead, growing at well above the 6%. Inflation was rising. The Fed started to speak about inflation and the need to lean against the winds. Our moves should become more conservative. Thus, we look at the big picture and try to understand what is happening. The environment tells us if the trend is bullish or bearish.

The decision to buy or sell a specific asset depends both on the environment and the specific value and conditions associated with that asset. For instance, a stock may be overvalued as measured by a P/E ratio for the stock relative to the P/E ratio of a market index. Although Treasury bonds may be doomed to trade in a range, corporate bonds or high-yield bonds may still be attractive. Later, we discuss these types of indicators in detail. The same tools guide us to decide if bonds are more attractive than stocks.

The second step in our investment process is to decide what to buy or what to sell. After we decide the environment supports a bull market, we decide which stocks or bonds to buy.   Let's limit our discussion to stocks. The attractiveness of some sectors and stocks within a sector depends on the level and trend of inflation. If the Administration policies are inflationary, we look at commodity driven (precious metals and energy) stocks. If interest rates decline, bank stocks become attractive. When interest rates rise, bank stocks become unattractive. In this book we develop a methodology to make these type of choices.

The third step in the investment process is when to buy or sell. The level of risk in the system determines when to buy or sell. Remember, risk relates to the probability of making money. When risk rises, the odds of making money drop. When risk drops, the odds of making money increase. We follow indicators to find if risk is increasing or decreasing. We need to know the current level of risk. Is risk high or low? Because this step relates closely to the next step we position ourselves to decide how much to buy and how much to sell.

The fourth step concerning how much to buy or sell depends on the level of risk associated with that specific asset. If the risk is very low then our strategy is to buy. If the risk is high then our strategy is to sell. If risk is low and expected to rise, what do we do? To answer this question, we need to look at how a poker player plays the game. When we begin the game, the unknowns are what the other players will do and what cards the other players will have. Yet, we want to play the game. If we do not play the game, our returns are below average. We put a chip on the table to play the game and expect a return. As investors, we do the same thing. We want to always be fully invested. The challenge is to invest in an optimal way.

The next step in the poker game is to look at the cards we are dealt. After we look at the cards, we can establish the level of risk we encounter if we play our hand. The level of risk is the odds of how much money we can make with our hand of cards. We start to discard cards based on the odds of getting better cards and winning over the cards held by the other players. As we play our hand, the game evolves and we establish who may hold a better hand. Based on that assessment, we raise our bet. As the game progresses and the bets increase, the amount of money put on the table increases with the probability that we will get the jackpot. If we realize the risk is high and the probability of making money is low, we fold and stop playing. This is the kind of decision process used to decide how much to invest in any market asset.

As investors, we go through the same mental exercise to decide how much to buy or sell. At the bottom of a bear market investors do not know how the game will evolve. In the beginning, investors chip in a little to stay in the game. Similarly, the poker player begins with a small bet to stay in the game. As the probability of making money increases, investors raise their ante. As market prices go up, the size of the investment increases because the odds of making money increase. When risk becomes too high, the same strategy is reversed. Investors gradually reduce their holdings in stocks. If the market keeps declining, we sell more. How much to buy and sell is the focus of money management. Thus, we continually adapt our portfolio to the changing financial markets and economic conditions.

Frequently, people hesitate and wait for more evidence. They want to see what the markets will do next. This could cost dearly. There is a saying in Zen: When in doubt, act. Hesitation is the worst enemy. Always sell a little or buy a little. But act. It is important to play the game. The worst attitude for investors is to think in terms of all or nothing. This leads to emotional conflicts. By buying or selling small amounts, investors stay in the game. It is important to play the game.

6. <u>The dynamics of risk management</u>

With respect to managing money and risk, we must establish a timetable to review our portfolio and strategies. Professionals review their strategies every day, every minute, as the data come through the screens. Avid investors may review their strategies every day or every week. Others prefer every month. What is important is that strategy and the assessment of risk is reviewed with regularity. The closer we keep our eyes on the performance of our portfolio, the more successful we become. If you do not have the time to do this task you have too many investments, too many stocks and/or bonds, and too many other assets. Choose a few assets and follow them very closely. If you do not have the time, ask a professional portfolio manager to provide a weekly summary of the value of your investments. If close monitoring of the performance of your portfolio is absent then odds of increased profits are low.

Each of us has our own personality and emotional preferences in life with respect to investing. Our ability to invest successfully also depends greatly on the rules we want to follow as we make decisions. Whatever your personality and emotional preferences, remember to:

(a) Review the environment for investments on a regular timetable,
(b) Review the performance of your portfolio on the same timetable,
(c) Review what caused a decision to buy or sell, and
(d) Modify your decision if the reality of a situation requires a mid-course correction.
(e) Take small steps to avoid painful mistakes when a change in investment posture is required.

A systematic approach is required to manage portfolio risk. Use a framework to collect the essential data needed for an investment program. Investors who follow a short horizon need to collect different information from those who follow a longer-term horizon.

Once we have the information, interpret the information using the tools presented in this book. For this purpose, we need to develop the skills to understand the meaning of the information that has been collected. The ideas in this book offer a way to interpret the data available from markets and government sources.

The dynamics of risk management

1. Collect the information.
2. Process the information using the tools in this book.
3. Develop investment scenarios.
4. Establish the odds of being right for each scenario.
5. Develop a strategy for the most likely scenario.
6. Implement your strategy gradually.
7. Measure your performance. Does your strategy and choice of assets provide the expected results?
8. Go to 1.

After the information is processed and the indicators are computed, we develop investment scenarios. This crucial phase of the process drives the investment strategy, selection of stock sectors, and types of assets for investment. The interpretation of the data may not lead to only one economic and financial scenario. Two or three scenarios may be formulated to reflect the position of the indicators. At turning points in financial markets and business activity, the use of multiple scenarios is helpful.

Some scenarios are more likely than others. For instance, if short-term interest rates drop, commodity prices drop, and the money supply grows for a few months then the odds favor higher stock prices. Another common scenario is a strong economy, higher interest rates, and lower bond prices. Growing commodity prices make commodity driven stocks attractive. If the economy is likely to grow slowly, we anticipate stable or lower interest rates and firm bond prices. We expect commodities to trade in a narrow range or head lower. Inflation would remain subdued. In a slow growth environment stock prices rise strongly. Thus, we must predict a most likely scenario. When we document a most likely scenario, we can develop an investment strategy and a plan to take advantage of it.

Even though we identify the most likely scenario, recognize that other scenarios exist. Doubts may arise on interpreting the data and other scenarios become credible. This exercise focuses on the issues and risks of the times. By assigning a probability to each scenario, we formalize the uncertainty in our analysis of the data.

<u>Examples of scenarios and their impact on asset prices</u>

1. **Strong economy**
    - Higher interest rates and lower bond prices
    - Rising commodity prices
    - Rising inflation
    - Stock market very selective

2. **Slow growth economy**
    - Stable or lower interest rates and firm bond prices
    - Stable or lower commodity prices
    - Stable or lower inflation
    - Rising stock prices

3. **Very weak economy**
    - Lower interest rates and strong bond market
    - Lower commodity prices
    - Lower inflation
    - Higher stock prices

After assigning a probability to each scenario, we develop a strategy that limits our losses. We re-design our strategy to take advantage of the new most likely scenario. All of these concerns integrate into our selection of assets (types of stocks or bonds) for our portfolio. To protect our portfolio from the downside risk and avoid costly mistakes, we gradually act on our investment plan. At some point in time, new evidence triggers an adjustment in our strategy. Thus, we recognize the change in our environment and adapt with a modified strategy.

Measuring the performance of our portfolio helps to choose investments and manage risk in our portfolio. If our strategy is successful, the returns of our portfolio are favorable. Even with a favorable return, we must monitor the performance of our assets and separate the strong from the weak ones. If our strategy is wrong, the returns are poor. We must go back to the first step in the dynamics of risk management and reconsider the whole process. The question is, “What did we miss?” Thus, we reevaluate the whole investment scenario, sector selection, and the choice of stocks. When we find and understand the reasons for poor returns, we avoid catastrophic results. Now, our management abilities come into play.

The above steps should be repeated at least every month to evaluate the success of our investment process. Does our strategy provide satisfactory results? Investors lose money because they do not use discipline to manage their investments. Quite often, people feel enthusiastic about the strong growth in market prices and their choice of assets. They forget to maintain the discipline to find out if the cards from the dealer were changing the risk of the game. They forget to ask, "Do I need a better strategy?" Successful investors do not just make money when assets go up in price. Successful investors make money when assets go down in price. For this reason, discipline is the order of the day. Review of our environment (the conditions that justify a strategy) is a repeating pattern. Any new strategy must be formulated to match the new environment.

7. Conclusions

The most important concept in managing money is an investment process. The investment process is a method that provides the tools to manage all your money, not just play money. People lose money because they forget to use discipline and to review the success and failure of their investment choices and strategies on a repeating pattern. A major cornerstone of an investment process is to assess the risk in the market place. The concept of investment risk is similar to the concept of risk in a game of strategy. A successful poker player constantly computes the risk of the game as the game is played. If the odds of winning increase, they raise their bets. If the odds of losing increase, they fold quickly. By comparison, if the odds are high of an asset price going up then buy now.

Realistic objectives are crucial. Investors recognize that chasing 20% returns, as in the late 1990's, is not a helpful investment objective. A high investment objective implies the ownership of volatile assets like technology stocks in the late 90's. The problem with volatile assets is, while their appreciation is rapid, their decline is equally swift. Investors avoid those pitfalls and use discipline to recognize that investments for the long term, at about 7–9%, are realistic. Realistic objectives point investors to sound strategies and investments; recognized values are less prone to sharp setbacks.

Successful investors achieve predictable and stable returns if they use methods and tools that encourage a review of their portfolio. They need to systematically establish, when, why, what, and how much they should sell of any specific asset. These decisions depend on what happens in the financial and business environment. Understanding financial environments is essential for selecting the investments in our portfolio.

Risk changes as businesses march through the various phases of the business cycle. Within a phase, the indicators tell us when to buy or sell. The decline of risk makes some investments particularly attractive. In contrast, the rise in risk will force investors to start selling and reduce their exposure to a particular investment. By acting gradually and adjusting our portfolio to the new level of risk we limit our losses and open up to new opportunities. Rather than think "buy" or "sell," we think gradually increase or decrease our position in any given investment. Thus, we avoid major mistakes and painful losses.

Our choice of assets depends on our investment strategy. An investment strategy depends on the outlook and the kind of economic features we expect. A strong economy warrants a strategy based on rising inflation, rising interests rates, rising commodities, and probably an uncertain outlook for stock prices. On the other hand, a weak economy justifies a strategy based on aggressive buying of certain stock sectors, and other assets like bonds. During such times, avoid assets like commodities, precious metals, and hard assets in general. Establish economic scenarios using the tools discussed in this book to develop strategies and invest successfully.

Finally, we discussed risk and the dynamics of managing risk. This process uses a series of steps to collect and process the information. The next step is to develop investment scenarios and establish the odds of profiting within each scenario. Successful investors develop and implement an investment strategy based on the most likely scenario and set limits to avoid large losses. Measuring and analyzing the portfolio performance is the final step to maximize the portfolio. We sell the losers and keep the winners after a keen analysis of our decisions.

In the next chapter, we begin to build the framework to develop an investment process. The first step is to introduce the economic and financial indicators needed to assess what is the most likely path of the financial markets and the economy. They are simple to follow. The indicators interact in a reliable repeating pattern. In the following chapters, you will learn how to use and interpret these indicators and integrate them into your investment process.