



## Ruminations on the Investment Process

Because the investment process is a very complex topic, I will cover it here in abbreviated form. The main steps are as follows:

**Determine your Goals and the Available Resources.** The first step is to determine what you want to accomplish. For example, many people have retirement as one of their goals (which we prefer to call “achieving financial independence”). Think about what this means to you. Visualize it. How you will spend your time each day? Now identify the earliest time you would like to retire. If that isn’t possible, how long is the maximum you would work? What standard of living would you like to enjoy in retirement? If that standard isn’t possible, how much *could* you live on? How much are you saving now toward retirement? How much *can* you save? How much would you *like* to save? How much volatility in your investments would you prefer? How much can you tolerate? There are tradeoffs in all these factors. Saving more can “purchase” an earlier retirement date. Retiring later can enable a more comfortable retirement lifestyle. Taking on more investment volatility (and thus earning a potentially higher return) may allow you to save less. Clarifying and identifying all of your goals and the resources available to meet them is an important first step to achieving those goals.

**Develop your Capital Markets Assumptions and Optimized Portfolios.** This section is necessarily technical and will no doubt not make much sense to you if you are not an investment professional. However, while most people and, appallingly, even many advisors don’t understand these concepts, they remain vitally important to the process. The second step is to develop a list of the categories of investments you will consider investing in. For *each* of these asset classes, you will need to develop an estimate of the future arithmetic mean return (as opposed to the geometric mean), the standard deviation, and the correlation with every *other* asset class. This data is then put into an “optimizer” (a type of software program) to develop (combined with experience and judgment) a set of model portfolios (or asset allocations) that are appropriate for different levels of risk and return.

**Perform a Monte Carlo Simulation.** A Monte Carlo Simulation is a quantitative technique for developing projections under conditions of uncertainty, like not knowing what the market will do in the future. This process combines the portfolios developed in the previous step with the goals and resources identified in the first step and lets you know which combinations are feasible. In other words, there may be *no* portfolios that give a high probability of meeting your ideal goals (such as retiring tomorrow on a very high income). We recommend continuing to adjust the plan until there is an acceptable probability of success in meeting your goals with a given portfolio.

**Implement the Plan.** It isn’t until this step that the actual investments are selected. The criteria here should be how efficiently and effectively the portfolio can be implemented by the investments.

**Monitor the Plan.** After the plan has been implemented, it must be monitored and adjusted as the goals and resources change or as the portfolio becomes out of balance when some asset classes return more than others.

**Notes:**

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