

# Explainable Machine Learning for Regime-Based Asset Allocation

Ruoyun Zhang  
Data Center  
China Asset Management Co.,Ltd  
Beijing,100033,China  
rz1495@nyu.edu

Chao Yi  
Data Center  
China Asset Management Co.,Ltd  
Beijing,100033,China  
yic@chinaamc.com

Yixin Chen  
Data Center  
China Asset Management Co.,Ltd  
Beijing,100033,China  
chenyx@chinaamc.com

**Abstract**—This paper explores an explainable AI model in the financial industry. Macroeconomic and market data serve as inputs of Hierarchical Clustering to distinguish among different economic regimes. Compared with traditional models such as Investment Clock, this method can adjust the classification standard in time according to recent market sentiment. The regime, therefore, can be interpreted by not only macro indicators but also investors' mood swings using Artificial Intelligence. When we compute the statistical characteristics of returns of each asset, we find that they can be well distinguished among regimes. This method can also identify the abnormally large wave of the stock market from 2015 to 2016 by separating it as an unusual regime, which cannot be realized by traditional methods. The clustering technique enables us to explain and understand the current market status and predict different assets' performances. Therefore, thanks to the superior interpretability of AI, the mean and variance of returns in each regime are estimated and viewed as viewpoints of the Black-Litterman asset allocation model to construct portfolios. To simulate the real situation, a dynamic backtesting method is used and asset weights change because of the rolling time windows. The results show that equipped with a simple timing strategy, the clustering technique can improve the results and yield excess returns. Some other machine learning techniques are also applied in an attempt to improve the model.

**Keywords**—Hierarchical Clustering, asset allocation, regime-switching, machine learning, explainable AI

## I. INTRODUCTION

Asset allocation optimization is one of the most important research fields in asset management. In the 1950s, Markowitz brought up the mean-variance model, seeking to maximize expected return given level of risk or minimize risk with a certain level of return. From then on, asset allocation started to change from simple methods such as equal-weighted or 60/40 rule, to the quantitative era. The optimal weights of the Black-Litterman model[1], an advanced model based on the mean-variance model, was explained by Guangliang He and Robert Litterman in 2002. They believed that it combines the market equilibrium and the view of investors: the weights increase when the view is more bullish and the magnitude increases as an investor becomes more confident about the view[2]. Research is conducted on the Black-Litterman model[3][4][5]. The Bayesian method used in the Black-Litterman model gives it

great flexibility. Investors can inject their subjective views based on their experiences to impact the model results.

Due to the explosion of large amounts of data, the passion for applying diversified data in asset allocation has been ignited. In addition to market prices, macroeconomic data has been widely used in multiple models for asset allocation research. James Chong and G. Michael Phillips incorporated their own factor economic climate rating and set up Eta profiles to depict sensitivity and responsiveness of portfolio to economic factors[6]. Regime-based asset allocation based on macro data is also popular[7]. Miroslav Kollar proposed in an article that rebalancing the portfolio based on macroeconomic regimes might produce more stable returns with lower volatility than the business cycle-neutral approach[8]. Another type of data, market sentiment, is also mentioned in various investing strategies[9][10]. Haiqiang Chen et al. created a sentiment index to identify market regimes[11]. Lorenzo et al. built a public mood-driven model for portfolio management[12]. As machine learning becomes popular, new techniques are introduced. Thomas Raffinot claimed that hierarchical clustering can be used to group different types of assets with similar structures[13]. Derek Snow summarized several portfolio weight optimization methods using the machine learning techniques, including supervised, unsupervised, and reinforcement learning[14].

In this paper, enlightened by research papers indicated above, we introduce the monthly market technical indicators along with macroeconomic indicators to cluster the economy each month into four regimes. For the regime of the current time point, we extract historical price information of all assets in the regime to calculate estimated mean and covariance of return, using them as priors to get the posterior mean and covariance in the Black-Litterman model and obtain portfolio weights. The clustering and asset allocation process can be achieved dynamically, using price information no later than the current time. In addition, we innovatively incorporate the selection of objective functions using a simple timing strategy when realizing the Black-Litterman optimization. At the end of each month, we compute the asset weights and trade at the beginning of next month. Using the WIND database, the backtesting shows that this strategy achieves an annual return of 22.53% and a Sharpe ratio of 1.06 from August 2010 to May 2020, which beats

the equal-weighted benchmark model and classical Black-Litterman model sticking to only one objective function.

## II. REGIME SWITCHING

### A. Merrill Lynch Investment Clock

Merill Lynch mentioned investment clock theory first in one of their reports in 2004[15]. The business cycle can be separated into 4 phases: reflation, recovery, overheat, and stagflation. Specific asset types can outperform the others in each phase.

- Stagflation: GDP growth slows but inflation remains high. A sharp rise in the unemployment rate will break the cycle. Cash is the best asset.
- Overheat: High inflation rises after robust economic growth. Government and Central Bank usually increase taxes and interest rates to reduce loan size. Commodities are the best assets.
- Recovery: The economy recovers after the recession. Indicators such as real GDP, employment rate, and corporate profit grow fast. Stocks are the best assets.
- Reflation: GDP growth is relatively slow and inflation is low. The central bank lowers short-term rates in an attempt to stimulate growth and inflation. Bonds are the best assets.

### B. Clustering Based on Macro and Technical Factors

Although investment clock theory has realistic meaning, in a time period when inflation and business are relatively stable, its effect is weakened. In addition, the criteria for defining each phase are relatively vague, and the types of investment assets are limited, which cannot be directly used in real-time trading strategies. Inspired by its logical framework, a model that includes more macro factors and reflects the economic status comprehensively is proposed. Economic status can be divided into 4 categories using Hierarchical Clustering. Hierarchical Clustering creates a nested clustering tree by calculating the similarity of data points. After defining the Euclidean distance, it merges the two nearest ones into one category and iterates this process repeatedly until all data points are merged into one category. We can produce any number of categories during the clustering process. There are many ways to calculate the proximity between two data points. Here, the Ward algorithm is used to minimize the increment of the sum of squared deviations after the two clusters are merged.

In order to better verify the effectiveness of clustering, we select representative major asset indexes as follows: CSI 300 Index, CSI 500 Index, CSI Mid-High Credit Bond Index, Shanghai Securities Treasury Bond Index, South China Commodity Index, South China Gold index. The macro factors mainly include the following categories:

- *Inflation indicators*: CPI year-on-year, PPI year-on-year
- *Economic growth indicators*: Output Growth of Industries year-on-year, PMI

- *Money supply indicator*: M2 year-on-year
- *Interest rate indicators*: 1-year Government Bond Yield, Maturity Spread (10-year government bond yield minus 1-year government bond yield)

Since the interest rate is daily frequency data, we need to convert it into the monthly frequency and take the monthly median as the monthly value.

In addition to the above indicators, we also test some leading indicators, such as power generation, consumer confidence, CICC CMI prosperity index, year-on-year fixed asset investment, etc. However, these indicators hardly improve the results and reduce annual returns, therefore abandoned in our model.

Taking into account the high sensitivity to new information and high volatility of stocks' price, and their close relationships with various markets, we calculate the 15-day Momentum (MOM) and 12-day Relative Strength Index (RSI) of the CSI 300 and CSI 500 indexes and take the difference between the maximum and the minimum value monthly to create short-term market technical indicators to reflect market sentiment and volatility. We have tried to take the monthly median, but the backtesting results are not as good as the difference between the maximum and minimum, so the latter is used. It should be noted here that due to the differences in the publication time of various economic indicators and the lag of monthly indicators, except for interest rates and market-related indicators, all other indicators are taken from the value of the previous month.

Macroeconomic indicators are noisy. In order to analyze their periodicity, we perform hp filtering on all non-technical indicators. All indicators are then standardized. After data preprocessing, there is a vector with indicators as its elements to describe the economic status for each month. We cluster the vectors, divide the business cycle into 4 regimes, and collect the price data of assets in each regime. Fig. 1 below shows the daily average logarithmic return of four clustering regimes during the period from August 1, 2009, to May 31, 2020.

Obviously, stocks have the biggest changes in different conditions, and the performances of CSI 300 and CSI 500 tend to be quite similar, which confirms their strong correlation. Commodities and gold show a relatively strong and negative

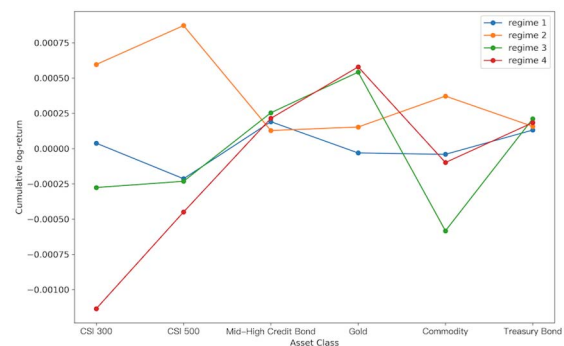


Fig. 1. Daily average log returns of each regime

correlation in regime 3. Government bonds and credit bonds are not highly distinguishable in different regimes. The statistical characteristics of regime-based data clusters verify the effectiveness of the clustering technique. For the regime in which stocks have good performance, such as regime 2, the performance of bonds is relatively unsatisfactory. This negative correlation is reasonable since during the time when stocks make great profits, people tend to invest their money in stocks while exiting from the bonds market with lower returns. However, when stocks experience depression, investors become panic and transfer their money to safe assets like gold. Regime 4 in the graph shows this situation.

Fig. 2 shows the normalized price series of all assets corresponding to clustering regimes from the beginning to the end of the backtest period. The four background colors represent four regimes.

It can be seen that the regime transitions are relatively infrequent, and the unusual rise and fall of the stock market between 2015 and 2016 have caused this part to be regarded as a single regime. From the end of 2018 to the present, the regime has changed regularly.

### III. DYNAMIC REGIME-SWITCHING ASSET ALLOCATION

#### A. Markowitz Mean-Variance Model

The Markowitz Mean-Variance (MV) model calculates the effective frontier of the portfolio based on the expected return and the covariance matrix of the input assets, so as to determine the portfolio that meets the optimization goal. The optimization objectives are diverse: minimizing risk when the expected return is certain; maximizing the Sharpe ratio; maximizing portfolio return under a given risk level.

However, the MV model is very sensitive to the inputs, especially expected return, which causes problems in practical application. The error of the estimated historical return is not insignificant and minimal estimation error of the data can cause the calculated optimal investment portfolio to deviate greatly from the theoretical optimal. In other words, this model lacks stability.

#### B. Black-Litterman Model

In 1992, the Black-Litterman (BL) asset allocation model based on the previous MV model was first proposed by Fischer Black and Robert Litterman of Goldman Sachs, which greatly improved the stability and practical value.

The model first uses the Capital Asset Pricing Model (CAPM) theory proposed by Sharpe et al. to calculate the equilibrium return of the market by observing the asset weights in the equilibrium market status. Taking the equilibrium return as a priori, it integrates the investor's subjective viewpoints of return to obtain the posterior return using the Bayesian method and then brings it into the Markowitz model to find the final optimal weight. This model effectively mitigates the errors caused by the direct use of mean estimation of historical returns and can be adjusted flexibly and timely.



Fig. 2. Price series after normalization with regimes as background colors

Assuming that the market equilibrium weight is calculated as the ratio of investment product market value and total market value, denoted as  $\omega_{eq}$ , the return of each investment product under the market equilibrium status, that is, the prior expected return would be:

$$\mu_0 = \delta \Sigma \omega_{eq} \quad (1)$$

Where  $\Sigma$  is the covariance matrix and  $\delta$  is a real number.

BL model has an opinion matrix  $P$ , which represents the opinion of absolute or relative return, and a vector  $Q$ , which represents the magnitude of return. For example, the return of investment product A is 2% higher than that of B, then

$$P\mu = Q \quad (2)$$

Where  $P=[1,-1]$ ,  $Q=[0.02]$ . Let the prior covariance matrix be  $\tau\Sigma$ . The diagonal matrix  $\Omega$  represents the confidence of each viewpoint, ranging from 0 to 1. As a result, the posterior expected return vector combined with subjective views is:

$$\mu_p = ((\tau\Sigma)^{-1} + (P^T\Omega^{-1}P)^{-1})^{-1}((\tau\Sigma)^{-1}\mu_0 + P^T\Omega^{-1}Q) \quad (3)$$

Black-Litterman's optimal portfolio weight is obtained by the MV model using the posterior expectation and covariance as inputs.

In our model,  $\delta$  is set to 2.5, and  $\tau$  is set to 1. After regime division, we take the monthly historical daily average logarithmic return of each regime as an absolute point of view and set the confidence level to 0.9 to obtain the posterior expected return. The market equilibrium weight is roughly equally divided, with CSI 300 and CSI 500 accounting for 0.2, and the rest accounting for 0.15. MV has a variety of objective optimization functions. The most classical ones are minimizing variance and maximizing the Sharpe ratio. During the backtesting, we found that the volatility of stocks can reach 40%, while the volatility of bonds is stable and remains less than 1%. The excessively high volatility of stocks makes bonds have an absolute advantage in the MV investment portfolio when using minimum variance or maximum Sharpe ratio as the objective function. Although the entire portfolio has been rising steadily for a long time, it mainly focuses on bonds. The return is also roughly the same as bonds. The results are shown in Fig. 3.

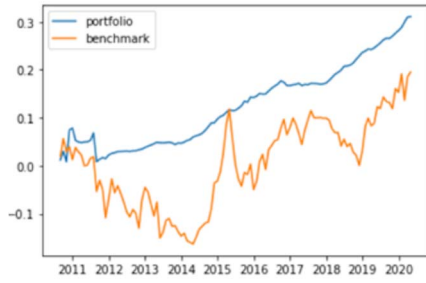


Fig. 3. Cumulative return of maximum sharpe portfolio and equal-weight benchmark

Under normal circumstances, profit and risk are positively correlated. Risky stocks, therefore, can generate more excess returns in specific time periods. We hope to increase the weights of stocks reasonably and solve the overconcentrating problem. To this end, the following attempts have been made:

- Set a range for the weights of assets, e.g., the weights of bonds not exceeding 0.5. In this way, the sum of bonds' weights is kept at the maximum value that can be obtained, and the remaining weight is transferred to other safer assets, such as gold. If we want to increase the weights of stocks, too many parameters need to be set, and the calculation of the model is of little significance.
- The L2 regularization penalty is added to the model, and the regularization coefficient  $\gamma$  is adjusted so that the weight of each asset is not 0. For the minimum variance objective, the optimization objective function changes from  $\min \omega^T \Sigma \omega$  to  $\min \omega^T \Sigma \omega + \gamma \omega^T \omega$ . Even if  $\gamma$  is small, the effect is significant. However, almost all of the six assets will reach a relatively high proportion, and there is little difference from an equal-weighted portfolio.
- Considering a compromise existing between Sharpe and return: return is often small when Sharpe is the largest, and when Sharpe is small, the volatility becomes high so return may increase accordingly. We try to weigh between Sharpe and return. Therefore, we adjust the parameter  $\gamma$ , calculate the minimum variance portfolio weight under each  $\gamma$ , and save the return and Sharpe of it. Then we take the portfolio weight with the largest Sharpe ratio among those whose returns are greater than the median of all returns. This method does not perform so well as the equal-weighted benchmark. One possibility is that the existence of  $\gamma$  reduces the overall Sharpe and return. It is unreasonable to directly use the expectations obtained from the model as a prediction of the future.
- Smooth the logarithmic return to artificially reduce the volatility of stock assets. The effect is not obvious, and the volatility of stock assets is still much greater than other assets.

The above attempts have problems and cannot be used in our backtest model. In our test, if the risk level of the investment portfolio can be fixed, such as 30%, the weight of the stock can increase with maximum return objective function. However,

there is still a problem if we use this function all the time: even when the stock volatility is not that large, the model always turns to risky assets, which makes the portfolio drawdown increase. Based on these observations, we propose the following innovative rotation model.

### C. Rotation of Objective Functions

Fig. 4 shows the annualized volatility with a 30-day rolling window of stocks from August 2010 to May 2020. It is observed that stocks have volatility exceeding 20% in certain time periods. At this time, a relatively large price rise and fall provide us with obvious profitable opportunities. Therefore, we hope that the model can appropriately bear risks to obtain higher returns when the stock market volatility is high. For this reason, we set the rotation of the objective optimization functions, which is a simple timing strategy. When the volatility of the stock market exceeds a certain value, say 20%, and there is a trend of upward breakthrough, we change the objective function to seeking maximum return under the risk level of 20%. The upward breakthrough trend is defined here as the current stock price being higher than the average stock price of the previous ten days. This method greatly increases the holdings of stocks at this time and brings significant excess returns.

### D. Other Attempts in Machine Learning Techniques

Instead of using historical returns, we also tried to add other machine learning models to predict returns and observe whether they can be combined with clustering to exert greater utility.

- Use the macro and technical indicators from the current month to the previous 20 months as features, and whether price increases or decreases next month as the label to train the SVM model and make the forecast. There are three ways to use SVM to predict results:
  - a) Inputs as BL viewpoints. When the forecast is increase, set a higher return viewpoint for this asset. It performs slightly worse than clustering model.
  - b) Used alone (without joining the BL model). For all assets that are forecasted as increase, equally divide the portfolio. It cannot beat the equal-weighted benchmark.
  - c) Combined with clustering, where the clustering weight and SVM weight (equal division of rising assets) account for  $\frac{1}{2}$ .

The graphs in Fig. 5 show the cumulative returns of three strategies. Obviously, the accuracy of the prediction of the SVM itself is not high, and the results are not greatly improved. SVM is not included in the final model.

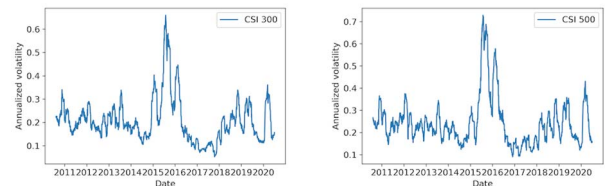


Fig. 4. Annualized volatility of 30-day rolling window of CSI 300 & CSI 500



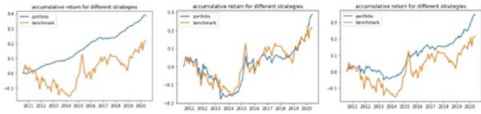


Fig. 5. Comparison of benchmark and strategy a) b) & c)

- Using the same features data as mentioned, and setting the step length to 20, the LSTM model is used to predict returns. The forecast results are regarded as the viewpoints of the BL model, and the forecast errors are regarded as the viewpoints' errors. Due to the lack of monthly frequency data and the random noise, this model cannot learn the trend well and is not included in our final model.

#### IV. EMPIRICAL RESULTS

According to the above, we calculate the updated weights at the end of each month from August 2010 to May 2020 and adjust the positions by trading at the beginning of the next month. In order to judge the positive effects of clustering and model objective functions rotation, we use an equal-weighted model and BL model with a single objective function as benchmarks for comparison. Fig. 6 displays our backtesting results. The first row depicts the changes in asset weights over time. Different colors represent different assets. From left to right, the models are the maximum Sharpe model, maximum return given risk model, and the rotation model respectively. The change of weights of the rotation model is more reasonable than the others. For the maximum Sharpe model, the risk aversion is so strong that the portfolio focuses primarily on treasury bonds and credit bonds, which are denoted by pink and dark red. The weights of the maximum return given risk model, however, rotate very frequently and always allocate all wealth to one asset, most of the time, stock. The rotation model can change the risk aversion level properly and use different objective functions effectively. The second row displays monthly returns during the whole backtest period. The orange line represents the equal-weighted benchmark. The return of the maximum Sharpe model vibrates slightly around 0, displaying a safe but not profitable feature. The return of maximum return model, on the other hand, has high volatility and causes serious losses occasionally. Compared with the other two, the rotation model has relatively higher returns than the first model and is relatively more stable than the second model.

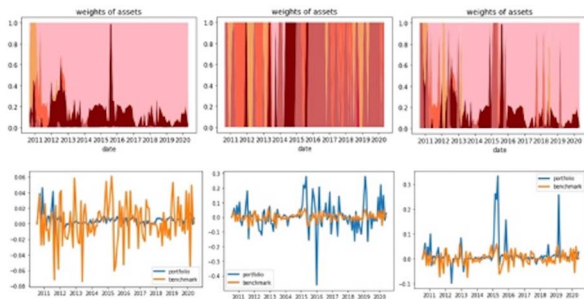


Fig. 6. Backtesting results. The first row depicts weights evolution through time of different models. The second row displays monthly returns.

At the end of the backtest period, the cumulative return of the equal-weighted benchmark portfolio is 21.5%. The cumulative return of maximum return portfolio with 30% annual volatility is 137.5%, and the cumulative return of the portfolio with maximum Sharpe ratio as the objective function is 56.3%. Combined two single objective function BL models, the cumulative return of the rotation model is approximately 213.5%. All three BL models applying the clustering technique significantly outperform the benchmark, and the rotation model is significantly better than the others. Fig. 7 shows the cumulative return curve of different strategies.

Analyzing the figure, we can see that the equal-weighted portfolio fluctuates around 0 and does not obtain obvious additional profits. The return of maximum Sharpe portfolio has grown steadily and is dominated by bonds' yields, which cannot capture the rising signals of the stock market, such as the astonishing rise of the market in 2015. The portfolio that maximizes returns with a fixed risk level has more violent volatility. Although it can achieve rapid growth in a short period of time, it also experiences sharp declines and higher risk. The rotation model, on the contrary, has the robustness and can quickly identify rising signals to enter the market while exit in time when the risk is too high, turning to safer assets. Table 1 shows the evaluation indicators of each model's performance during the whole backtest period, and the annual risk-free interest rate is set to be 2%.

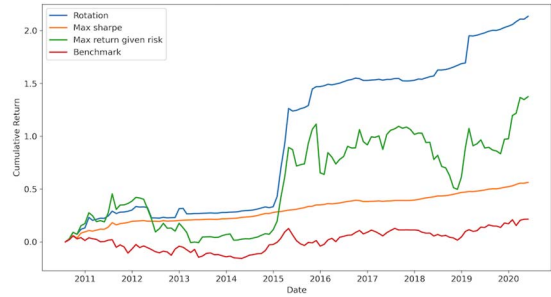


Fig. 7. Cumulative return of different strategies

TABLE I. BACKTESTING RESULTS

Indicators	Model Performance			
	<i>Equal weight</i>	<i>Maximum sharpe</i>	<i>Maximum return</i>	<i>Rotation</i>
Annual return	2.27%	5.94%	14.50%	22.53%
Beta	1.00	0.09	2.22	0.69
Alpha	0.00	0.04	0.12	0.20
Annual volatility	9.49%	2.95%	33.80%	19.30%
Sharpe ratio	0.03	1.34	0.37	1.06
Information ratio	N/A	0.39	0.41	1.08
Maximum drawdown	20.18%	2.15%	31.72%	8.26%

The annual return of the rotation model explicitly outperforms the rest of them. In addition, the Alpha of this strategy, which represents the strategy's ability to beat the market, is the largest among all models. The maximum drawdown of it is constrained below 10%, much smaller than the maximum return model achieving the second largest annual return in the table.

## V. CONCLUSION

The change of macroeconomic environment has a certain ability to explain the performances of assets. Market sentiment also explains the rise and fall of prices. The fear of future uncertainties prompts people to flock to the gold or bonds market when negative events occur. It is not uncommon to select assets according to investors' reactions. Using the AI technique, we are able to explain the market status by both the macroeconomic environment and market sentiment. It allows us to capture information of hotspot events such as policies or natural disasters, which might cause great insecurity among investors. After our analysis and data visualization, it can be clearly seen that the AI technique successfully integrates market and macro data in order to comprehensively recognize the regime.

This paper sets an asset allocation framework that combines the economic regime division by hierarchical clustering with the Black-Litterman model. It is also found that setting up the rotation of the objective optimization functions can solve the imbalanced weights problem and obtain more excess returns.

Firstly, we preprocess macroeconomics data with hp filtering and combine it with market technical indicators to divide the economic regimes into four categories using clustering. Then, for each regime, we assess the historical returns' performances of all assets and compute the empirical expectation and covariance. They are used as viewpoints to calculate posteriors for the BL model. BL optimization weights are then calculated through the rotation of the objective optimization functions to achieve dynamic asset allocation. The results show that during the backtest period from August 2010 to May 2020, the annualized return of the model reaches 22.53%, and the Sharpe ratio is about 1.06, which is significantly better than the equal-weighted benchmark portfolio and other counterparties. The model integrates macro-scenarios and has strong flexibility. It can respond to market fluctuations in a timely manner. Experiments show that it successfully captures two large upswing signals of the stock market and withdraws before the plunge.

In conclusion, due to its high interpretability by visualization and numerical analysis, an explainable AI model is incorporated

into an asset allocation strategy and performs well in the last decade, which shows the great prospects of explainable AI in financial industry.

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