Goals-Based Investing: Integrating Traditional and Behavioral Finance

Portfolio Management
for Financial Advisers

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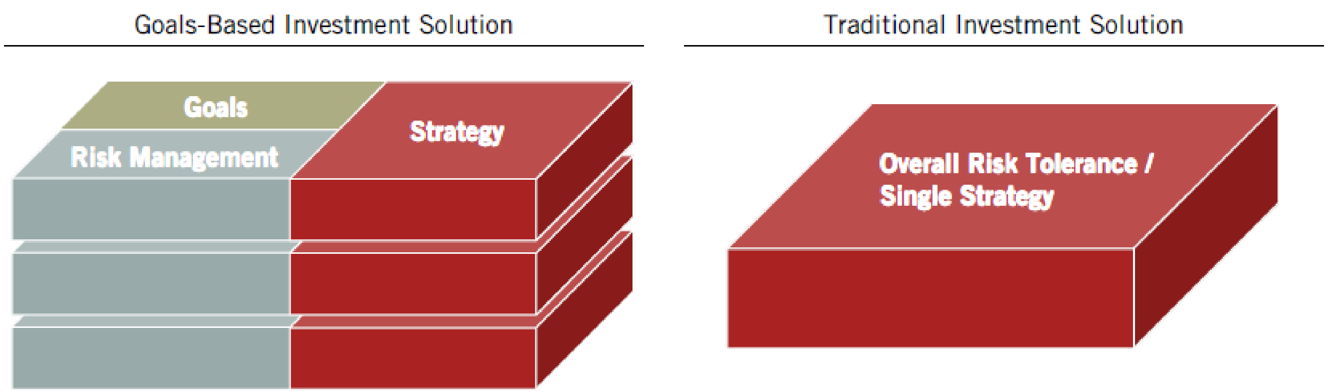
Goals-Based Investing

- The idea is to focus on investing toward client's specific objectives as opposed to benchmarking to an index
- The investement principles are defined from the perspective of the investor, rather than the practitioner
- Instead of traditional measures of risk and return, client's goals are used to measure portfolio efficiency
- Risk management is based on measurements to capture the risk of failing to achieve the client's goals
- Investment strategies are then built around to meet each of the client's goals, rather than creating an overall portfolio strategy



Goals-Based Investing

EXAMPLE

PRIORITY	NOW	LATER
WANT TO	**Examples:** Buy vacation home or travel to Europe with family **Your goals:** **Investment objective:** grow assets	**Examples:** Leave estate for my children or retire in golf community **Your goals:** **Investment objective:** grow assets
HAVE TO	**Examples:** Pay living expenses **Your goals:** **Investment objective:** preserve guaranteed sum	**Examples:** Retire comfortably, put kids through university **Your goals:** **Investment objective:** protect against losses, while maintaining steady growth, have enough when the time comes
	TIME	

Source: http://www.seic.com/docs/Canada-Advisor/SEI-GoalsBasedInvesting-CA.pdf

Goals-Based Investing

The possible benefits of defining portfolio efficiency in terms of client goals

1) Client should be able to see clearly how investments strategies are aligned with their own goals
2) The risk exposure will be explicit to the investor, as it is expressed in terms relating to the achievement of the stated goals
3) The investor will likely maintain greater discipline and thus increase likelihood of achieving goals

Traditional risk measurement methods utilize portfolio statistics such as standard deviation and tracking error

☑ Easy to calculate based on the properties of the portfolio

⊗ Limited ability to capture market behaviour

⊗ Traditional risk measures are inconsistent with the way investors experience risk

Goals-Based Investing

One of the main tenants of behavioral finance is the following concept:

INVESTORS ARE NOT RISK ADVERSE, BUT RATHER LOSS ADVERSE

In other words: *investors are concerned less about uncertainty than they are about losing money.*

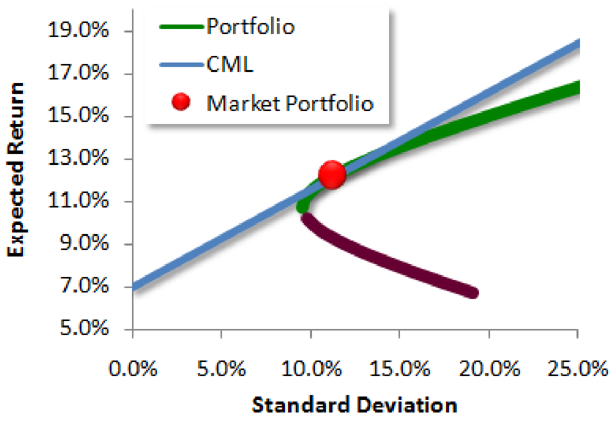
⬇

The risk measurements should account for the risk of loss in terms of the likelihood that the loss will occur and/or the amount of the loss

Goals-Based Investing

The traditional Markowitz efficient frontier

is based on investors making trade-offs between expected portfolio return and portfolio risk



Frontier of risk and reward opportunities for lifestyle expenses

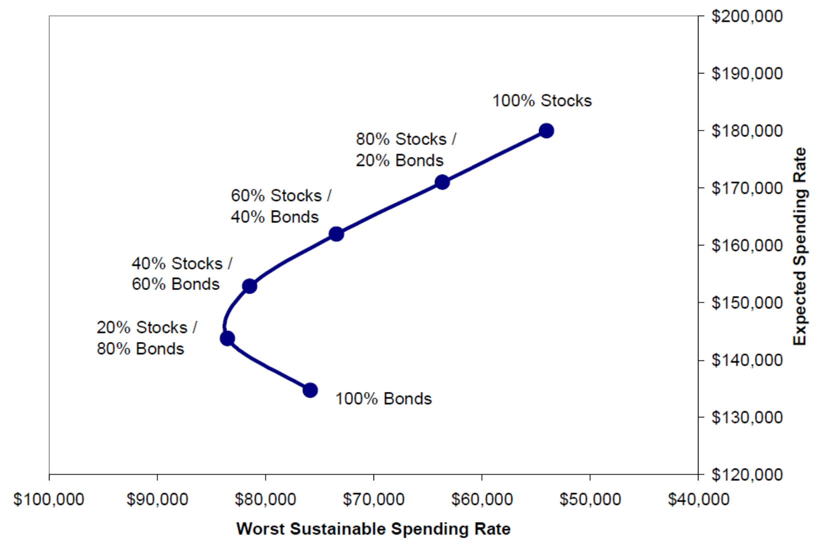
- shows trade-offs between the expected spending rate and the worst sustainable spending rate
- **the reward** is defined as maximizing the amount of spending the portfolio is expected to fund
- **the risk** is shown as spending falling below the expected level

Goals-Based Investing

Frontier of risk and reward opportunities for lifestyle expenses

- **The sustainable spending rate** is defined as the amount of spending that the investor can be confident of maintaining without running out of capital
- **The worst sustainable spending rate** considers the lowest level that the sustainable spending rate might reach at any time prior to the horizon

FRONTIER OF REWARD AND RISK OPPORTUNITIES FOR CURRENT LIFESTYLE EXPENSES



Source: Ibbotson Associates, SEI Investments

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Measuring Risk to Lifestyle Goals

- The well being of individual is dependent on the portfolio's performance throughout the investment period, rather than just the average or final outcome
- The risk measure considers the path the investor will experience between the present date and the horizon date
- **The worst sustainable spending rate** is estimated prior to the horizon date. It rates factors in the lowest level that sustainable spending might drop to at any time prior to the horizon date.

! NOTE !

This risk measure **is an event specific** rather than period specific as it considers the risk that sustainable spending rate could fall to the certain level (which is the event), regardless of the time at which the event might occur.

LIFESTYLE PROTECTION STRATEGIES

➡ Involve aligning the investment process with spending goals

➡ They are constructed to manage the trade-offs between sustainable spending and potential loss

➡ It requires absolute return objectives rather than relative return objectives

Measuring Risk to Lifestyle Goals

INVESTING FOR FIXED PLANNING HORIZON

- Typically involves an investment horizon to coincide with life event such as retirement, or college, a simple time period for planning purposes
- The investor’s reward can be measured as the expected portfolio value at the horizon date, or the assets growth rate
- Risk can be measured as the amount of capital that could be lost or the worst portfolio value at the horizon date

> *“It is not so much that people hate uncertainty–but rather, they hate losing.”*
> *– Amos Tversky*

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CASE STUDY

Mr. and Mrs. Smith are young professionals with considerable lifetime income potential. They have a baby on the way and intend to forego some of that income while their children are pre-school age. They hope to take a Caribbean cruise before their second baby is born and have saved enough money to do so; they are now waiting for the right package at the right price. They also intend to buy a home in the next two to five years to accommodate their growing family, and have started saving for a down payment. They would like to begin saving for their children’s education and their retirement years, and they both agree that if all goes well, one of their dreams is to own a vacation residence in their later years. Both of their employers offer defined-contribution retirement plans.

CASE STUDY

YOUR TASK

Following that, employ a goals-based approach for each of your clients' financial goals: preserving their vacation funds, saving for a down payment on a house, maintaining their current lifestyle if one of them chooses to stay home with the children (and saving for child-care expenses if they do not) and supplementing their retirement savings if possible.
In addition, identify investment objectives corresponding to each goal (i.e. growth, stability)

Fill in the table:

	TIME HORIZON	
	NOW	LATER
WANT TO		
HAVE TO		

CASE STUDY

ANSWER

	TIME HORIZON	
	NOW	**LATER**
WANT TO	– Caribbean cruise (Stability) – Stay-at-home parent (Stability)	– Vacation residence (Growth)
HAVE TO	– Child care expenses (Stability) – Down payment for home (Stability)	– Children's education (Growth/Stability) – Retirement (Stability/Growth)

THANK YOU!