Goals Based Investing – What is it and what are some of the challenges?

The profession of financial planning is one that is about helping people to achieve their financial or investment GOALS. As such, it is arguable that in fact all financial planners are in affect already doing goals based financial planning. Yet whilst the profession of financial planning is about assisting investors to achieve their investment goals, the framework which is currently utilised by the majority of the financial planning profession is in fact not aligned to assisting financial planners achieve this for their clients.

Goals based investing means defining portfolio efficiency in terms of clients goals, rather than the traditional measures of return and standard deviation.

In essence to implement goals based investment planning we need to personalise the wealth management framework. At the core of this, personalisation is bringing the investor to the centre stage. Risk is defined based on the clients' goals, therefore we utilise measures that capture the risk of failing to achieve those goals.

Then investment solutions are created that match each goal to an appropriate strategy, rather than a traditional approach of creating one single portfolio.

Changes in the structure of retirement plans, life expectancy and the globalisation of financial markets have increasingly thrust greater responsibility back on to the individual for their own financial future. The needs of the individual impose different considerations than simply the averages of the market.

Financial markets have undergone a profound transformation over the last decade of the 20th Century. International markets have become increasingly integrated which has been fostered by the deregulation of cross-border capital flows. Financial innovation has also increased the complexity of financial products that are now more widely available. Overall, the landscape of investment opportunities has become more accessible, yet heterogeneous, and also more interdependent. The contagion risk that characterised the global GFC revealed some very important dynamics of the correlations among global asset classes, and that is – it appeared that risks became over concentrated rather than being diversified away, but also that asset classes co-move faster than expected.

In addition to the effects of the global financial crisis, some important academic work has been done post-GFC which has enabled solutions to be developed that reduce some of the tensions that exist between the assumptions of standard finance (which requires statistical measures such as standard deviation and sharpe ratios), and the viewpoint of the individual investor, which is based on goals and human psychology.

The most important work was published in 2010 in the Journal of Financial and Quantitative Analysis entitled 'Portfolio Optimisation with Mental Accounts' by Harry Markowitz, Sanjiv Das, Jonathan Scheid and Meir Statman. The importance of this work is twofold, firstly the founding inventor of Mean Variance portfolio theory – Harry Markowitz – acknowledges that this work does not answer many of an investors questions. This is of importance due to the fact that the current practice of building efficient portfolios is based on the work done by Markowitz through the mean variance portfolio theory. Yet in this paper, Markowitz argues that in reality mean-variance portfolio theory needs to integrate with behavioural portfolio theory to produce a new framework. This is where the second point comes in – as Markowitz argues that by integrating mean-variance portfolio theory with behavioural portfolio theory, the definition of risk changes to the probability of failing to reach a goal or threshold limit. He then goes onto argue that investors need to have various investment strategies that are targeted to specific goals – which he refers to as 'Mental Accounts', and these mental accounts or goals each have their own level of risk and their own specific target or goal.

Earlier work produced by Jean L.P. Brunel in 2007 and 2008, whilst of importance and critical in the building of knowledge and depth to goals based investment theory, has carried less weight than the work that was done by Markowitz in 2010, and also in 2012.

Behavioural theorists have shown that the notion of an overall risk tolerance is flawed, and that in fact investors have multiple attitudes about risk. Refer to the work by Meir Statman in 2002.

Importantly, both the work done by Brunel and Markowitz - labelled as either goals based or mental accounts - recognise what the behavioural theorists proved in the early 2000's. That is, that investors compartmentalise assets for downside protection from assets that they use for upside potential. Markowitz, in his work of 2010, acknowledges that investors are better able to state thresholds and probabilities for sub-portfolios than for an aggregate portfolio. The net result being that better problem specification delivers superior portfolios to the traditional theory which suggests that an allocation should be established for an investor's total portfolio.

One of the key benefits of a goals based approach is that it reduces the friction between the advisers' perspective, which is based on traditional investment principals, and the investors perspective which is determined by goals and psychological make-up. As a result, when strategy selection is more closely linked to the investors goals, it becomes more difficult for damaging behaviours to take hold.

It has been found that investors are better equipped to select investments when decisions are framed in terms of their goals – such as the ability to sustain a potential loss of 10%, 20% or greater.

Goals based portfolios are built to manage the trade-off between expected returns and potential loss rather than managing risk versus an index. Performance objectives are stated in absolute rather than relative terms.

The principle drawback to a goals based process is its complexity, which makes it challenging to implement. Advisers need to work through what is the appropriate level of customisation and what the process for investment strategy development is. Currently there are two main streams or frameworks that are dominating the goals based landscape. One is to work by way of a “bucket” approach, where each bucket is assigned a fundamental goal such as liquidity, income, capital preservation and growth. An equally effective approach is to build a suite of investment products that can be matched to a common investor goal. For example, a strategy to limit the risk of a decline in portfolio value of 10% or more (short-term lifestyle expenses which needs a high degree of principal stability). Another example is a portfolio that is to limit risk at a particular time in the future without regard to principal stability. In other words, it allows for volatility as long as it does not affect the outcome at the horizon date – such as retirement.

In summary, goals based planning improves upon traditional approaches in the areas of measuring risk, risk profiling and managing behavioural biases. At a time when failed strategies have forced investors to rethink plans for their lifestyle, family and community, the investment industry needs to create better solutions.

Goals based planning represents an opportunity and a compelling alternative to robo-advisers which may offer low fees but, by and large, continue to work off outdated investment concepts. Through goals based planning, investors gain an intuitive, graphical representation of their portfolios, which supports better comprehension and improved confidence, whilst also satisfying regulatory requirements for transparent risk-based communication.

It engages clients and engenders loyalty by making their goals the priority.

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