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Goal-Based Investing: Investing with a Purpose

The wealth management industry has been predominately shaped by Harry Markowitz's Modern Portfolio Theory since the 1950's. Recently, however, a new strategy called goal-based investing has been gaining traction as investors grapple with the side-effects of the Great Recession. Goal-based investing combines traditional portfolio management with behavioral economics to create a new philosophy where investment decisions are based not off a single risk/reward profile, but instead off multiple risk/reward profiles.

Traditional portfolio management is based upon many assumptions, including that an investor is perfectly aware of the interworkings of the markets. This is often not the case for the average investor and leads to investors creating portfolios with either too much or too little risk. This misjudgment of risk tolerance reared its ugly head in 2008, when many investors realized that their risk tolerance was much lower than their portfolio's equity exposure.

As Dan Nevins noted in his paper "Goal-Based Investing: Integrating Traditional and Behavioral Finance", behavioral theorists have shown that investors have not just one, but multiple, attitudes about risk. For example, most investors are unwilling to risk capital that has been allocated to cover their children's education costs. However, they are willing to invest funds not needed for lifestyle expenses, for instance saving for a new boat in more aggressive investments.

Utilizing goal-based investing can help investors identify specific goals, assign a distinct risk profile for funds earmarked for those goals, and then implement a specific plan to attain these goals. Adopting these techniques can help investors tolerate volatile and even bear markets.

Identifying Your Goals

Identifying clear-cut goals is the basis of goal-based investing. In traditional portfolio management, you measue your portfolio's success against a benchmark, often a blended benchmark or the S&P 500. However, it all becomes relative in an instance such as 2008 when your portfolio "beats the S&P 500" but still loses 20% in the year before your retirement.

Goal-based investing does away with benchmarks and instead uses the attainment of your goals as a measure of success. This shift in focus helps investors elongate their time horizons and alleviates concerns about short-term market volatility.

In goal-based investing, investors should separate their goals based on time horizons and priority. Each goal will then have a separate risk profile based on these characteristics. The key to goal-based investing is matching the time horizon and priority of a particular goal to a specific asset allocation. Achieving shorter-term goals will require a different asset allocation than longer-term goals.

This table categorizes the goals of an investor based on the time horizon and priority of the goal. Goals that have a higher priority and a shorter time frame should be invested in a more conservative manner, whereas goals with longer time horizons can be invested in a more aggressive manner.

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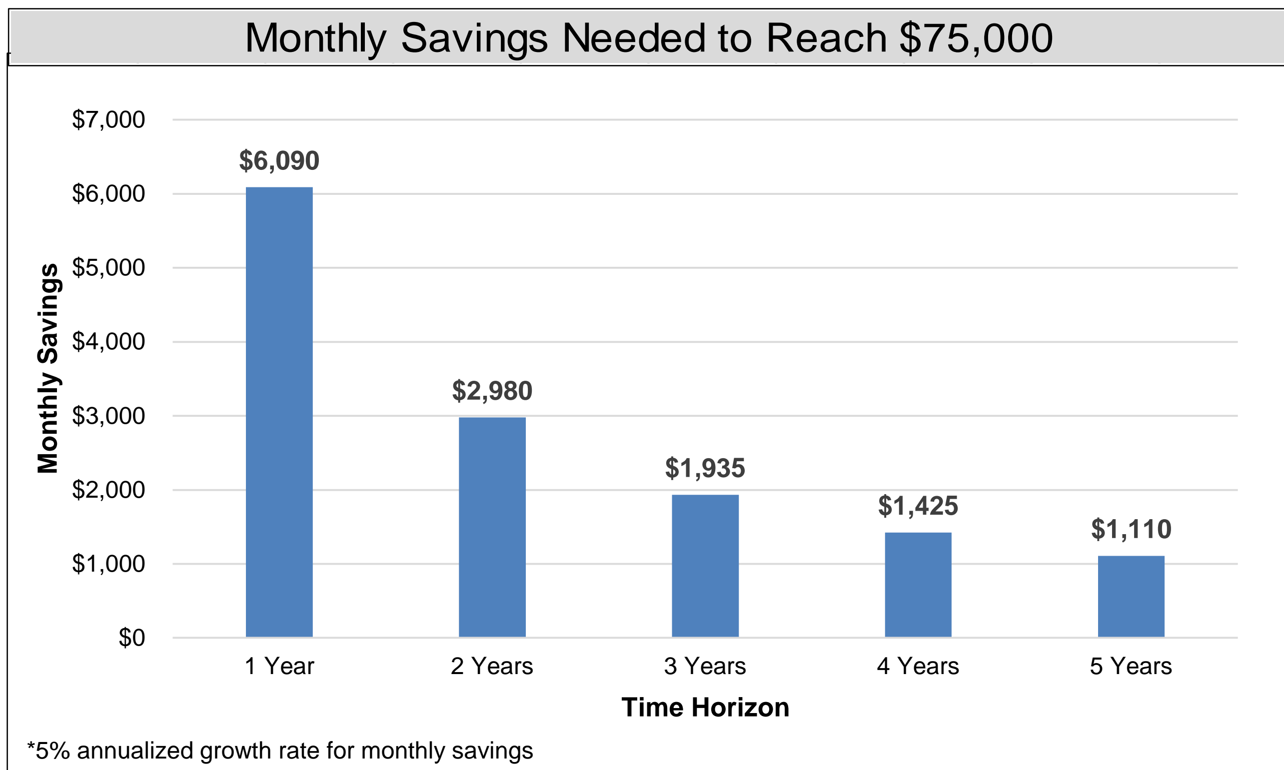
Selecting Your Risk Profiles

Once you have a set of goals, you need to assign a different risk profile to each one. For example, every investor has basic needs and living expenses, which must be met every year. There is little margin for error when it comes to paying these expenses. Hence, the funds allocated to these short-term liabilities should not be invested in an aggressive manner. However, if you want to buy a boat when you retire in 15 years, you can invest these funds in more aggressive asset classes and be able to withstand the increased volatility.

Time horizons are key to assigning risk profiles to your goals. The figure below shows how a longer time horizon greatly reduces the amount of money you need to save per month to reach a goal.



The chart shows the monthly saving amount that an investor would need to achieve his goal of saving $75,000. As the investor's time frame increases, the amount that he needs to save each month greatly decreases.

A longer time horizon also translates into greater risk tolerance. If an investor needs an annual return of 5% over 20 years to reach his goal, he will endure years of returns greater than 5% and years of returns less than 5%. If in year 2, his portfolio declines -3%, there will be no reason to panic because his longer-time horizon increases his margin for error.

However, if he had only a 5-year time horizon, he would have substantially less time to recover the lost capital and attain his goal. Therefore, a shorter time frame often translates into a more conservative allocation in order to preserve capital.

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Using a Fluid Asset Allocation to Increase the Probability of Success

Similarly, as an investor's time frame narrows, he should adjust his asset allocation accordingly, which is particularly important for investors nearing retirement. Experiencing a decline of 20% or more in the year before retirement would substantially change the retirement lifestyle of the individual. Therefore, as a goal approaches its horizon, an investor should gear back the allocation to increase the probability of success.

The figure below demonstrates the effect of the sequence of returns on a retiree's portfolio. Both investors start with a $2,500,000 portfolio going into retirement. Each year they withdraw 5% of the initial portfolio value for living expenses. The withdrawal amount grows each year with inflation (assumed to be 2%). Investor A's portfolio grows at the annual return of the S&P 500 from 1989 to 2008. Investor B's portfolio also grows at the annual return of the S&P 500, but the returns occur in reverse order starting with 2008.

The Impact on the Timing of Returns for a Retiree

Investor A - Early Gain						Investor B - Early Loss					
Year	Rate of Return	Balance after Returns	Withdrawal of Initial Investment	Amount Withdrawn	End-of-Year Balance	Year	Rate of Return	Balance after Returns	Withdrawal of Initial Investment	Amount Withdrawn	End-of-Year Balance
1	31.69%	$2,633,800	5.00%	$100,000	$2,533,800	1	-37.00%	$1,260,000	5.00%	$100,000	$1,160,000
2	-3.10%	$2,455,252	5.13%	$102,500	$2,352,752	2	5.49%	$1,223,684	5.13%	$102,500	$1,121,184
3	30.47%	$3,069,636	5.25%	$105,063	$2,964,573	3	15.79%	$1,298,219	5.25%	$105,063	$1,193,156
4	7.62%	$3,190,474	5.38%	$107,689	$3,082,785	4	4.91%	$1,251,740	5.38%	$107,689	$1,144,051
5	10.08%	$3,393,529	5.52%	$110,381	$3,283,148	5	10.88%	$1,268,524	5.52%	$110,381	$1,158,143
6	1.32%	$3,326,486	5.66%	$113,141	$3,213,345	6	28.68%	$1,490,298	5.66%	$113,141	$1,377,157
7	37.58%	$4,420,920	5.80%	$115,969	$4,304,951	7	-22.10%	$1,072,806	5.80%	$115,969	$956,836
8	22.96%	$5,293,367	5.94%	$118,869	$5,174,499	8	-11.89%	$843,068	5.94%	$118,869	$724,200
9	33.36%	$6,900,711	6.09%	$121,840	$6,778,871	9	-9.10%	$658,298	6.09%	$121,840	$536,457
10	28.58%	$8,716,272	6.24%	$124,886	$8,591,386	10	21.04%	$649,328	6.24%	$124,886	$524,442
11	21.04%	$10,399,014	6.40%	$128,008	$10,271,005	11	28.58%	$674,327	6.40%	$128,008	$546,319
12	-9.10%	$9,336,344	6.56%	$131,209	$9,205,135	12	33.36%	$728,571	6.56%	$131,209	$597,362
13	-11.89%	$8,110,645	6.72%	$134,489	$7,976,156	13	22.96%	$734,516	6.72%	$134,489	$600,027
14	-22.10%	$6,213,425	6.89%	$137,851	$6,075,574	14	37.58%	$825,518	6.89%	$137,851	$687,667
15	28.68%	$7,818,049	7.06%	$141,297	$7,676,751	15	1.32%	$696,744	7.06%	$141,297	$555,446
16	10.88%	$8,511,982	7.24%	$144,830	$8,367,152	16	10.08%	$611,435	7.24%	$144,830	$466,606
17	4.91%	$8,777,979	7.42%	$148,451	$8,629,529	17	7.62%	$502,161	7.42%	$148,451	$353,710
18	15.79%	$9,992,131	7.61%	$152,162	$9,839,970	18	30.47%	$461,486	7.61%	$152,162	$309,324
19	5.49%	$10,380,184	7.80%	$155,966	$10,224,218	19	-3.10%	$299,735	7.80%	$155,966	$143,769
20	-37.00%	$6,441,257	7.99%	$159,865	$6,281,392	20	31.69%	$189,330	7.99%	$159,865	$29,465
				$2,554,466	**$6,281,392**					**$2,554,466**	**$29,465**

Both Investor A and B begin retirement with $5M and withdraw 5% of their portfolio each year (5% increases with inflation). The difference is that Investor A's portfolio returns the actual return of the S&P 500 from 1989 to 2008, whereas Investor B's portfolio returns are in reverse order, starting with 2008. At the end, they have the same average return, but Investor A has a much greater ending portfolio value.

At the end of 20 years, Investor A's portfolio grew to $6.3M, whereas Investor B's portfolio shrunk to only $29K even though they both had the same average rate of return over the 20-year period. The stark contrast in ending portfolio values illustrates the significance of the timing of returns on the growth of a portfolio.

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Implementing a Plan to Reach Your Goals

Once you have a set of goals with their respective risk profiles, you need to implement a plan that will help you achieve success. While most investors will focus on traditional investment portfolios to reach their goals, there are other tools that can be beneficial to achieving your goals.

Active Indexing

The rise in availability and popularity of ETFs makes active indexing a beneficial tool for an investor looking to grow capital while at the same time reducing volatility and costs. Active indexing requires tilting the asset allocation of the portfolio to undervalued areas of the market or areas that you think will perform well in the prevailing market conditions.

Research has shown that individual stock picking does not result in higher returns relative to simply investing in an index itself. Therefore, investing using index funds will reduce the cost of investing, but at the same time likely capture greater returns.

Annuities

Annuities are a great tool to use for achieving high priority goals that have little margin for error, such as paying for basic living expenses in retirement. One concern for all retirees is longevity risk – the risk of outliving one's money. Lifetime income annuities address this concern by paying out a guaranteed amount for a guaranteed amount of time, such as the lifetime of the annuitant.

Annuity payout rates typically exceed bond and CD yields and do so at a lower risk. The larger payouts mean that a retiree could invest a smaller amount in an annuity to generate the same amount of income as bonds and CDs. Therefore, they will have excess funds which they could now invest in a more aggressive manner for growth.

An annuity is a good vehicle to use for achieving a high priority goal, such as basic living expenses in retirement. However, annuities may not be for everyone, as they may require a lock-up of capital in some cases.

Staying Goal-Oriented Reduces Pressure of Market Volatility

The most important benefit of goal-based investing is that if you set your goals, have specific risk profiles for each goal, and have a plan, then you do not need to stress about market volatility. Funds earmarked for your shorter-term goals will be allocated more conservatively and therefore will be less exposed to market volatility. Funds set aside for your longer term goals have a more distant time horizon and therefore more time to recover from any capital lost from short-term volatility. Whether your goals are putting your kids through college, buying a new house, collecting art, or giving to charity, adopting goal-based investing can help you achieve these goals with less stress than traditional portfolio based investing.

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