CLIENT GUIDE: GOALS-BASED INVESTING, A DIFFERENT STORY

SEI New ways. New answers.*

Hanna Wang*

www.successiongroup.co.uk
The landscape of the asset management industry has changed - increased requirements from regulators across the world to provide a high level of professional financial advice; more customised service demanded from clients who are equipped with an afflux of information. The UK adviser market has been and is still adjusting itself assiduously to the Retail Distribution Review and MiFID II. With more scrutiny from the regulators and more competition from web-based adviser models, the question for UK advisers is not whether to adapt, rather it's how quickly can they differentiate themselves from their peers. It's time for advisers to tell a different story.

The adviser industry has principally acknowledged the necessity to transit from a pure product provider to a holistic service provider that fully understands client needs. Two major challenges lie in the centre of this transition; advisers need to demonstrate their value by tailoring intangible financial advice to clients' unique and tangible goals. A survey done by CEB Wealth Management Executive suggests that about 35% of high-net-worth individuals assess the success of their portfolios based on their own financial and life goals; whereas only 23% of those would judge success by performance against benchmarks1. To achieve long-term success and sustain client relationships, advisers also need to develop a process that can better manage human and financial market behaviours. Studies from behavioural theorists have evidenced that human preferences and biases can undermine financial success2. To align financial investments with clients' specific life goals while addressing the negative effects of behavioural biases, a framework has been proposed by financial theorists: Goals-Based Investing.

Since Harry Markowitz laid the groundwork of “Efficient Portfolios” in 19523, modern portfolio theory has been the main concept that influences most investment processes. However, the “optimal” portfolio didn’t always stand the test of time. In 2003, SEI authored the white paper “Goals-Based Investing: Integrating Traditional and Behavioral Finance”. The paper proposed a new approach modifying traditional investment theory with the observations from behavioural theorist: a goals-based investment approach defining portfolio efficiency in terms of client goals instead of returns and standard deviations, redefining investment principles from the viewpoint of the investors rather than the practitioners4. In 2012, CFA institute published a study “Goals-Based Wealth Management in Practice” acknowledging that Goals-Based Investing can offer a high degree of flexibility and responsiveness to client needs with a practical level of standardisation5. Some Wealth Managers like SEI have been providing Goals-Based Investing programmes for over a decade, helping advisers to devise a client-centred investment process.

The traditional investment process is to allocate all client assets into a single portfolio. Goals-Based Investing avoids a single asset allocation; rather it identifies separate goals and treats them separately. For long-terms goals, it makes sense to assume that one may take more risk than immediate goals. Similarly, one may want to take less risk with those “have-to-have” goals and accept more risk for discretionary “nice-to-have” goals. According to clients risk profiles, each goal is linked to a risk management objective and investment strategy. Each combination of goal, risk management objective and investment strategy may comprise a separate sub-portfolio and all these sub-portfolios constitute a full investment solution6.

1 CEB Wealth Management Leadership Council, “Using Goal-Based Planning to Deepen Client Relationships”, Webinar Materials, 29 May 2014
2 Quantitative Analysis of Investor Behavior 2015, DALBAR
3 “Portfolio Selection”, Harry M Markowitz, Journal of Finance, 7 (1952), pp. 77-91
Goals-Based Investing can better manage behavioural biases which can be detrimental to long-term investment success; it can also help clients invest according to their individual needs and time horizons.

Tellingly, such an approach allows financial planners to track clients’ investment in a more holistic manner and monitor clients’ financial conditions from their perspectives and relative to their own goals.

In implementing Goals-Based Investing, short-term lifestyle goals are MORE vulnerable to investment failures, therefore a low risk tolerance and stability-focused strategy should be considered. Apart from meeting current lifestyle requirements, clients may want to reserve funds for children’s education or to pass on their wealth to the next generation. In an effort to meet these objectives, an investment strategy should have a longer time horizon than current lifestyle goals. Moving up the financial planning pyramid, philanthropic goals or other “nice-to-have” desires for some clients could utilise growth-focused portfolio. Below exhibit illustrates an example of Goals-Based Investing in practice for a young professional couple.

Goals-Based Investing can better manage behavioural biases which can be detrimental to long-term investment success; it can also help clients invest according to their individual needs and time horizons.

Tellingly, such an approach allows financial planners to track clients’ investment in a more holistic manner and monitor clients’ financial conditions from their perspectives and relative to their own goals.

<table>
<thead>
<tr>
<th>TIME HORIZON</th>
<th>NOW</th>
<th>LATER</th>
</tr>
</thead>
<tbody>
<tr>
<td>WANT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Cruise (Stability)</td>
<td></td>
<td>- Holiday home (Growth)</td>
</tr>
<tr>
<td>- Stay-at-home parent (Stability)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>NEED</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Childcare expenses (Stability)</td>
<td></td>
<td>- Children’s education (Growth/Stability)</td>
</tr>
<tr>
<td>- Deposit for home (Stability)</td>
<td></td>
<td>- Retirement (Growth/Stability)</td>
</tr>
</tbody>
</table>