Does Goals-Based Investing Help Achieve Better Investor Outcomes?

By Jean L. P. Brunel, CFA®

Though goals-based wealth management was pioneered in the early to mid-2000s (Brunel 2003, 2005–2006; Nevins 2004; and Chhabra 2005), the concept did not get much traction until 2010. The crucial catalyst was the publication of a seminal article by Sanjiv Ranjan Das, Harry Markowitz, Jonathan Scheid, and Meir Statman that concluded that mental accounts are substantially equivalent, mathematically, to mean-variance optimization (Das et al. 2010). These authors combined the classical work of Nobel Economics Prize laureates Bill Sharpe and Harry Markowitz that led to the development of modern portfolio theory and more recent research by Hersh Shefrin and Meir Statman (2000) on the impact of behavioral finance on portfolio theory; this helped alleviate much of the criticism that had been leveled at goals-based portfolio optimization. This criticism was based principally on the sub-optimality that resulted from dividing a whole portfolio into sub-components (Brunel 2006). Das et al. (2010, 2011) recommended revisiting the definition of risk, moving away from return volatility and focusing instead on the probability of missing a goal, a definition that is more intuitive to many individuals and families.

Goals-based wealth management makes sense because individuals and families have multiple goals, multiple time horizons, and multiple required probabilities of success, one for each goal. This differs from institutions, which more often than not have one single goal and one single time horizon. In the institutional framework, the notion of a utility function, which can express the investor’s risk/return trade-off, makes great sense; thus selecting the optimal portfolio at the tangency point between the investor’s quadratic utility and the efficient frontier is quite natural. But how does one figure out a top-down utility function when the investor has a variety of goals, some of which may initially appear contradictory (Brunel 2015, 57–66)?

The new process depends on advisors being both able and willing to be interpreters and help individuals identify all their goals with some degree of specificity, and evaluate whether they are achievable given capital-market realities. Advisors also need to see this interpreting process as continuous rather than punctual. They need to help relieve individuals of the requirement to learn financiales, the jargon of the industry, and focus on issues expressed in their own day-to-day language, in the way they actually experience them.

This article focuses on the question of whether and how this approach may help investors experience better outcomes. The article recalls the main features of the goals-based asset allocation framework, discusses the experiential differences in the way individuals perceive the process, shows the benefits accruing to investors, and presents a material change for the industry to consider in the way advisory firms are structured.

Goals-Based Asset Allocation
Policy formulation in a goals-based wealth management environment comprises four elements (see figure 1):

1. Describe each and every goal, including its specific time horizon and a specific forecast of detailed cash flows, regular or not, outgoing or incoming, and some estimate of the required probability of success for each. Certain goals may be expressed as labels, such as growth or capital preservation, with some current dollar amount required to be allocated. In those instances, one may bypass the next two elements, constructing a portfolio that fits the label thus expressed and allocating the assets postulated.
2. Identify the minimum return necessary over the defined time horizon with the required probability of success. This is done with a series of generic modules designed to meet a wide range of goals, or is based on an individual optimization of the portfolio best suited to meet a set cash flow over the given time horizon with the required success rate.

3. Use that return as the discount rate to compute the present value of the assets needed to meet the given goal within its required parameters.

4. Once subportfolios are created for each goal, they can be aggregated to form the investor's investment policy, using the asset-weighted average of the various exposures to the various asset classes or strategies.

How Individuals Experience Goals-Based Wealth Management

In a traditional one-portfolio, one-utility investment relationship, the bulk of the client experience is centered on the actual performance of the portfolio, whether solely focused on return or extending to some analysis of risk-adjusted returns. Investors who are comfortable with the typical institutional investment process may feel at ease looking at the portfolio's performance in the light of actual performance of markets. Yet, experience does suggest that the vast majority of individuals correctly believe that one cannot eat relative performance. Thus, it is not unusual for individuals to feel systematically dissatisfied. When their portfolios rise in value, but not as much as equities in a bull market, they are dissatisfied because they did not fully participate in the rally, reflecting the need to hold some fixed-income exposure to deal with spending requirements. When the value of their portfolios falls, but not as much as equities in a bear market, they are also dissatisfied—as predicted by behavioral finance, which teaches us that individuals worry about changes in states (Kahneman and Riepe 1998)—because they experience some loss, reflecting the fall in the price of those equities needed to help meet longer-term, growth-oriented targets.

A crucial benefit of an approach that identifies each and every goal, in as much depth as needed, is that the test of investor satisfaction has changed. It no longer solely rests on portfolio returns but rather on whether each goal has been satisfied or appears on track to be satisfied at its set horizon with the required success probability.

For goals that involve meeting a well-defined cash-flow requirement, the ultimate test of success revolves around the following two simple questions:

1. Was I able to cut the checks I expected to have to cut during the year?
2. Are the assets left in the portfolio sufficient to cover the expenses I expect over the relevant remaining time horizon?

For goals that involve some bullet payment—i.e., a lump sum paid out once rather than a series of periodic payments made at regular or irregular intervals—at some future point in time, the test will involve comparing the compound rate of return on the subportfolio from inception to the discount rate used to compute the amount of assets needed to fund that goal. Though this is the conceptual equivalent of a relative return analysis, it will seem considerably more natural to an investor because it will echo the way the subportfolio was originally constructed.

Yet, in the end, the most important benefit of the approach does not really involve actual portfolio performance. It is the fact that investors become more directly wedded to their wealth. Having spent time identifying goals, time horizons, and degrees of urgency of each goal, investors have taken a huge step toward a better understanding of their relationship with their wealth. Too often, even for very affluent families, there is a profound disconnect between “my wealth” and “what it does for me.” Investors often have an amorphous understanding of how much of their wealth is used to meet each of their goals. Going through the process of identifying what proportion of current assets is required to meet each and every goal helps change that very rough perception to a real sense of what the wealth is doing to and for the investor. We have seen investors change their spending patterns, not because they could not afford their current level of expenditure, but rather because they felt uncomfortable allocating so much of their assets to themselves, often at the expense of their heirs or philanthropy.

This wedding takes on an even more critical dimension for investors who have both financial and real assets. Often, the real assets will have acquired a sense of indispensability such that they may represent both a drag on the family’s expenditures—because they must be maintained—and a challenge when the family’s financial assets otherwise appear insufficient for it to maintain its current life style. Understanding the nature of the family’s relationship with all its assets—both those that earn an ongoing financial return and those that require some maintenance-related cash outflow—helps the family adjust its lifestyle accordingly, often planning for the disposal of surplus real assets as and when needed, rather than being confronted with a difficult decision that must be made under time pressures. This may not make the blow associated with selling certain real assets any more pleasant, but the fact that the sale can be anticipated and planned, and that there is logic to it, can make it easier to execute when necessary.

Have We Improved the Investor’s Outcome?

In some way, answering this question requires one to define its terms. Ostensibly, it would not be sensible to argue that an outcome defined in terms of absolute returns has been materially improved.
Why would that be? After all, nobody says that goals-based portfolios are any more efficient. The only improvement that might be noticeable relates to investors who are overly cautious and who can take more risk once they better understand how their assets and their goals relate. A corollary of this is that one could also argue that investors who take too much risk might also see a better outcome to the extent that the risk of falling short, or substantially short, of their goals should be reduced.

Yet, the real improvement is not in terms of better investment outcomes as measured by returns, risk-adjusted or not. The true improvement relates to helping the investor become more familiar with what financial markets can and cannot do for them; correspondingly, it also helps them appreciate how the various goals they have are—or are not—achievable, with the required probability of success and over the time horizon they choose. The true improvement is that both objectively and theoretically, one is helping the investor to gain comfort and to learn how to deal with both the wealth and the advisor.3 Understanding the limits of one's wealth is, unfortunately, a skill that quite a few investors need to learn; yet, appreciating that one's wealth can do a lot more than some modest goal is also crucial. I have seen investors who were concerned they had barely enough to live on literally light up when told that they could dream bigger. They could go beyond their elementary needs and wants and start to consider wishes and dreams. Similarly, understanding that a goal that cannot be achieved with the required urgency over 10 years, for instance, can become perfectly reasonable if the time horizon is extended by a few years4 is also a major improvement in the way the investor experiences his or her wealth.

An Important Caveat

It does seem that one can safely argue that goals-based wealth management does help investors experience better outcomes, but this does not come without costs to the advisory industry. The most important among those relates to the structure of most advisory firms. Moving to a goals-based advisory framework requires all firms to appreciate that each investor's investment policy will be unique; thus, they are liable to have more investment accounts than clients, because many clients have pockets that are truly theirs and pockets—such as trusts—where the ownership of the assets have moved to some other person or entity, and which cannot therefore be mingled into the original investor's policy.

This means that execution and compliance costs could quickly balloon out of control unless each advisory firm is able to construct a process that allows it to become more systematic in the way it conducts its work. Figure 2 illustrates a conceptual framework allowing a firm both to provide a customized solution to each client and yet achieve sufficient operational efficiencies to ensure that it maintains or raises profitability. The main insight is that providing tailored solutions does not have to mean providing Saville Row tailoring.5 Indeed, one is talking of mass customization rather than exclusive tailoring. A telling analogy is that of a custom-made racing bike; the frame is truly made to the exact measurement of the rider, but each of the pedals, gears, or brakes is selected for the rider from mass-produced components. Limiting the example to the frame of the bike, the components of that frame are not custom-manufactured; they are simply cut to the appropriate dimensions from mass-produced tubes, just as the cloth of a custom-made suit is not specially made, but simply cut to the measures of the client.

The advisory firm needs to appreciate that some activities are generic to all clients and others must be highly specific. There is no need to have a specific capital market forecast for each client, for instance; practically, one only requires two sets of forecasts to reflect pre- and after-tax considerations.6 It is thus possible for each firm to construct a set of goals-based modules that ought to cover the full efficient frontier and be sufficiently different to avoid unnecessary complexity or overlap.7 Similarly, there is no need to adjust one's tactical market expectations to each client's circumstances; there is a need to be able to adapt any tactical portfolio rebalancing or tilting to the specifics of each client's investment policy, to satisfy regulatory authorities that all clients are receiving the same—and the full extent of a firm's—insights. By contrast, the middle column shows that each client will have unique goals, time horizons, and urgency levels, and thus will need unique portions of wealth allocated to each appropriate module. In short, the process is totally client-focused when dealing with policy formulation and ongoing review that such policy remains

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**Figure 2: Goals-Based Wealth Management Advisory Summary**

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<thead>
<tr>
<th>Firm-Wide Process</th>
<th>Client Process</th>
<th>Specific Client Goals</th>
<th>Specific Client Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cap. Market Expectations</td>
<td>+</td>
<td>Definition of Client Goals</td>
<td>+</td>
</tr>
<tr>
<td></td>
<td>+</td>
<td>Assets Needed for Each Goal</td>
<td>+</td>
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<td>+</td>
<td>+</td>
<td>Goals-Based Modules</td>
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<td>Specific Client Allocation</td>
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<td>Specific Client Allocation</td>
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appropriate,8 but it is generic when it comes to capital markets, up to and including manager selection—though adjustments may be needed when minimum investments are considered or where diversification may appear excessive for smaller portfolios.

Conclusion
Goals-based wealth management appears to be the suitable industry response to the fact that individuals differ materially from institutions. Table 1 illustrates a few of these differences. The two most important seem to be the redefinition of risk as the probability of missing a goal and the fact that an individual’s risk profile must be defined through a bottom-up process.9 The improvement that each individual should experience in terms of investment outcome touches not so much on an increase in returns but rather in a greater degree of comfort with how assets are working to allow needs, wants, wishes, and dreams to be achieved, all the while avoiding nightmares, fears, concerns, and worries.

Jean L. P. Brunel, CFA®, is managing principal of Brunel Associates, LLC, which serves ultra-high-net-worth individuals and their advisors. He received IMCA’s inaugural J. Richard Joyner Wealth Management Impact Award in 2015. jean@brunelassociates.com.

Endnotes
1. Brunel (2015) provides an example of a process that may be used to estimate the appropriate required probability of success without forcing the investor to delve into statistical jargon. It suggests a couple of word sequences that should help the advisor to interpret the urgency of the goal. It recommends using “needs, wants, wishes, and dreams” to distinguish the urgency of goals that the investor is trying to achieve, and “nightmares, fears, worries, and concerns” for those the investor is trying to avoid.

2. This minimum required return is different from the average expected return for the optimal subportfolio, whether it is derived from a generic set of modules or individually optimized. The return we are seeking is the one that will be met or exceeded with the required probability of success over the required horizon.

8. One of the several reasons that might lead one to conclude that a policy needs to be revised relates to client needs changing or evolving. This occurs both as time horizons tend to roll forward (for instance, something that I expected to do—perhaps stopping some given expenditure—10 years from now may appear still desirable as I get closer to the 10-year horizon) and as certain expenditure forecasts prove erroneous.

9. The individual’s risk profile can be viewed as the average of the risk profile associated with each goal weighted by the percentage of total assets needed to meet that goal as required.

References

Table 1: Institutional and Individual Ways of Defining their Goals

<table>
<thead>
<tr>
<th>Goals</th>
<th>Institutions</th>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time Horizon</td>
<td>Single</td>
<td>Multiple</td>
</tr>
<tr>
<td>Risk Measure</td>
<td>Return Volatility</td>
<td>Probability of Missing Goal</td>
</tr>
<tr>
<td>Return Determination</td>
<td>Average Expectations</td>
<td>Minimum Expectations</td>
</tr>
<tr>
<td>Risk Determination</td>
<td>Top-Down</td>
<td>Bottom-Up</td>
</tr>
</tbody>
</table>

A portfolio having, for instance, a 5-percent expected return and a 7-percent expected return volatility will only meet or exceed 2.2 percent at the end of a 10-year time horizon with a 90-percent probability. 3. Kahneman (2011) makes the point that we have two distinct decision systems within our individual minds: one that is fast, but liable to jump to the wrong conclusion, and the other that is slower and a heavier energy consumer, but which is more reliable. He points to the fact that one needs instinctive responses at times (they are the one that use the first system), but must be able to rely on reasoned processes when circumstances require it. Being able to know how to help clients use the right system at the right time is one of the keys to being a great advisor.

4. Of by changing the required probability; lowering the required probability for a goal is equivalent to agreeing that the original urgency associated to that goal has been lowered a bit, for instance by changing a need into a want, or a wish into a dream.

5. Savile Row is a street in Mayfair, central London, famous for its exclusive tailors, providing bespoke apparel to a very select clientele. It is meant here to connotate special and ultimate exclusivity.

6. At most, one might need to play with tax rates to reflect specific state circumstances. Obviously, one might also need to translate forecasts in different currencies when advisors have clients whose base currency is not the U.S. dollar.

7. These typically would start with a portfolio totally invested in liquid or illiquid equity with a duration of less than a year at the low end of the risk spectrum and extend to a portfolio totally invested in liquid or illiquid equities at the high end of that same volatility spectrum. Experience suggests that one rarely needs more than six to eight portfolios for clients who accept all investment strategies, including liquid or semi-liquid alternatives as well as illiquid investments. A set of long-only, traditional portfolios probably would not need more than five or six choices.