By now the concept of goals-based wealth management is nothing new, and it is much discussed across our industry. But the practical application of its concepts—the nuts and bolts of actually doing goals-based wealth management—remains elusive and difficult to implement on a scalable basis.

This article is an attempt to help that evolution take place—to try and articulate why a goals-based approach matters by doing the following:

- highlighting some of the potential flaws of the more traditional approach;
- discussing a why vs. what portfolio-construction approach;
- illustrating what a goals-based approach might look like from a proposal-generation and performance-reporting perspective; and
- summarizing how advisors might use a goals-based approach to differentiate themselves in an increasingly digitized and commoditized wealth management industry.

What Problem Are We Trying to Solve?
The notion of goals-based wealth management has its academic roots in behavioral finance and behavioral economics. Very simplistically, behavioral finance can be thought of as the study of why supposedly rational investors frequently make seemingly irrational decisions about their money.1

Behavioral finance had its academic roots in prospect theory, developed by social scientists Daniel Kahneman and Amos Tversky, which posits that people have an asymmetrical view of risk in that they fear bad outcomes roughly twice as much as they enjoy good outcomes (see figure 1). This risk-aversion propensity potentially results in investors making decisions that are not aligned with the actual risk/reward profile of the investment in question.

Table 1 summarizes many of the more commonly analyzed behavioral-finance mistakes and the corresponding irrational investor behavior consequences they engender, and figure 2 humorously illustrates typical investor behavior.

Behavioral finance does an excellent job of describing ex post facto why people behaved the way they did, but that is of limited use in forward-looking portfolio management.

So the problem to be solved, then, is how to incorporate behavioral finance into portfolio construction and performance reporting...
Assume you are the chief executive officer of GotRocks Wealth Advisors and you run a successful practice with $1.5 billion in assets under advisement, with an average client size of $7.5 million. You are proud of your independence and your business model, which is fee-only and focuses on client service, objective advice, and a comprehensive total-wealth solution.

Your offering includes:

- no proprietary products;
- a high-touch service model;
- asset allocation, portfolio construction, and open-architecture manager selection;
- comprehensive tax and estate planning; and
- philanthropy, family governance, and wealth transfer solutions.

Does this sound familiar?

A Thought Experiment

In a different study, The IBM Wealth Management Customer Focused Enterprise Study (September 2007), IBM surveyed 1,200 investors with at least $500,000 to invest and asked them a series of questions. Based on their responses, the investors were placed in one of three categories with respect to their feelings toward their wealth managers: Advocate, Apathetic, or Antagonistic. Among the more interesting of the resulting data points was that just 31 percent of those categorized as “apathetic” toward their advisors agreed that “the quality of reports meets expectations.”

Why Performance Reporting Matters

Many advisors fail to realize that, once a new client has been on-boarded and invested, the quarterly performance report is one of the most tangible tools the advisor has to show investment added value on an ongoing basis. A 2010 research study on client satisfaction from Chatham Partners and Investment Metrics indicated that three of the top 10 things driving satisfaction with consultants among institutional investors were reporting-related:

- #2: Clarity of investment reports
- #5: Timeliness of investment reports
- #10: Reporting capabilities of website

In other words, client advocacy matters, and performance reporting can help.

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Now assume you meet a new $14-million prospect who just sold her company, and
she asks for an investment proposal. Based on your understanding of her goals and objectives, you propose the following:

- Large-cap U.S. stock funds: 15%
- Small/micro-cap U.S. stock funds: 15%
- Developed international stock funds: 15%
- Emerging market stock funds: 10%
- Core and satellite bond funds: 30%
- Alternative investment strategies: 15%

You tell your prospect that, based on back tests and Monte Carlo simulation analysis, this portfolio has an expected return of 9 percent with an expected standard deviation of 15 percent.4

Furthermore, all your selected managers have terrific benchmark-relative performance, information ratios, upside/downside capture, and peer universe rankings. You share with your prospect all the data and supporting spreadsheets that prove your claims.

Your prospect stares at your proposal, looks up, and says, “I trust you.”

You get your prospect signed and invested, and it’s now time to send her first quarterly performance report, which probably is laid out something like Table 2 (which is also probably pretty close to exactly what your new client sees when she looks at it).

As a trained investment professional, this is a perfectly legitimate way to summarize performance—you need to know how the overall portfolio and your selected managers did on both an absolute and benchmark-relative basis over multiple time periods.

But take a step back and ask yourself, “What sort of irrational investor behavior might I be encouraging with this performance report?”

- Short-term thinking: The first performance number she sees is the most recent quarter.
- Anchoring to irrelevant benchmarks: Why does she care about the micro-cap index? She doesn’t.
- Mental accounting: Highlight how each respective bucket of her portfolio performed, rather than how well the portfolio performance is actually meeting her stated investment outcomes.
- Focus on return without considering risk.
- No indication of how she is actually progressing toward her financial objectives (i.e., no “progress to plan”).
- You’ve shown her what is in her portfolio without explaining why it is there.
- You’ve presented her with information in a foreign language (financial jargon), which you will then explain by speaking slowly and loudly.
- You have summarized her portfolio performance without also summarizing everything else you did for her that added value to her financial life.

All of this begs the question, “Is there a better way?”

### Thematic Portfolios

Thematic investing refers to building and managing investment portfolios with the objective of solving specific client problems or exploiting specific investment opportunities. Importantly, thematic investing does not nullify the principals of modern portfolio theory (MPT) or require the use of esoteric or exotic investment strategies.

Under MPT, the objective of portfolio construction is to maximize the portfolio Sharpe ratio, or risk-adjusted return. In thematic investing, the objective is to solve a problem, identify a goal, or take advantage of identifiable trends in the larger macro-economic environment.

An academic definition of alpha is that it represents excess investment performance derived from manager skill. A non-academic definition (but one with which many advisors might agree) is that alpha represents anything an advisor does with respect to the portfolio that the client finds value in and is willing to pay for.

If one accepts this definition of “practitioner alpha,” it opens up the opportunity to build and manage portfolios on the basis of why vs. what—by defining the portfolio components by why they are in the portfolio, not by what they are (large-cap, small-cap, fixed-income, etc.). Figure 3 illustrates this multi-alpha portfolio approach.

One can easily imagine other thematically designed portfolios such as an inflation hedge portfolio or a yield and income or a natural resources shortage portfolio—each one constructed on a why vs. what basis.

### A Goals-Based Wealth Management Approach

Perhaps one of the most-discussed—and potentially powerful—applications of thematic investing is the concept of goals-based wealth management. Industry thought leaders such as Jean Brunel, Ashvin Chhabra, and Meir Statman have written...
extensively about the benefits and practical applications of a goals-based approach, but only in the past three to five years has technology advanced to the point where this approach can be adopted on a consistent and scalable basis by advisors.

Figure 4 illustrates Ashvin Chhabra’s Wealth Allocation Framework and is a good example with which to examine the multiple components necessary to adopt and implement a goals-based approach.

If an advisor wanted to build and manage these types of portfolios, how would he or she go about it?

First, each of the identified investment objectives (or buckets) would need the following:

- A stated investment goal
- A defined time horizon
- A desired or expected level of risk and return
- An appropriate benchmark for evaluation purposes
- Appropriate reporting metrics and capabilities
- An appropriate optimization methodology (or the decision to not optimize)
- Acceptable loss metrics
- Defined and acceptable percentage probability of failure
- A dollar allocation amount

For example, an investor with $10 million to invest might wish to allocate $5 million to the “stay rich” bucket, $3 million to the “market participation” bucket, and $2 million to the aspirational or “get richer” bucket. Each bucket would then need to be defined in terms of the above-mentioned bullet points, and each bucket would have different answers for each bullet point (probably).

It might be fairly easy to visualize this process and explain it to clients, but it is far harder to actually implement. First, the advisor’s proposal-generation system must accommodate a goals-based approach. Second, the advisor would then need to (almost by definition) subjectively map each underlying investment strategy to its appropriate bucket, and then be able to disaggregate those investment strategies from the accounts they sit in and remap them to the appropriate buckets for performance reporting purposes.

Figure 5 is an intentionally busy illustration of this disaggregation and remapping process. It also illustrates the reality that this is not an approach that can be hand-built or managed without appropriate technology.

Once an advisor has the operational capabilities in place, however, the power of the goals-based approach becomes increasingly apparent:

1. The portfolio has been built to address specific investor objectives.
2. The portfolio is proposed and reported on in the same intuitive way the investor thinks about his/her money rather than in advisor-centric MPT-speak.
3. From a reporting perspective, the focal point of advisor/client communication moves from client-irrelevant market benchmarks and individual manager performance toward a client-centered progress-to-plan approach.

Differentiating a Wealth Management Practice in a Race-to-Zero Environment

The wealth management industry is rapidly commoditizing itself, with a corresponding “race to zero” in terms of pricing of previously...
high value-added services. Consider the following headlines over the past 12–18 months:

• “Charles Schwab Ready to Unveil Free ‘Robo-Broker’ Service” (Reuters, October 6, 2014);
• “Goldman Sachs Explores Liquid Alternatives in the ETF World: Can Goldman Sachs put ETF Investors on a Liquid Diet” (Bloomberg News, October 21, 2014);
• “SEC Set to Approve Novel Eaton Vance Exchange-Traded Product: Less Than a Month After Rejecting Nontransparent ETFs, Commission Set to Back a New and Possibly Cheaper Way to Trade Funds” (InvestmentNews, November 6, 2014).

The fact that previously higher-fee products and services are more widely available now on a lower-cost basis does not mean they are better solutions, nor does it mean the end of wealth management as we know it.

But it is reflective of the world advisors now operate within, which is characterized by the following:

• Disintermediation of information flow
• Potential industry disruption via technology and robo or digital online advice
• Active management seems to be getting more difficult to practice successfully
• The democratization of investment solutions (exchange-traded funds, exchange-traded mutual funds, liquid alternatives, etc.)

• A new generation of investors who:
  » Want to be more involved in the decision-making
  » Are more cost/value/tax sensitive
  » Are more interested in risk management, transparency, and liquidity
  » Are less interested in traditional stock/bond portfolios and, perhaps most importantly
  » Are increasingly interested in open or nontraditional investment approaches and solutions (specifically, future investors will care about performance but will view that performance through the lens of the impact it has on personal objectives and perceived social needs—i.e., more goals-based/outcome-oriented investing and less benchmark-relative investing)

Wealth management has entered a post-product, post-service state of evolution. It is now a design-oriented industry that needs to be focused on the client experience. By adopting a goals-based approach to wealth management services, advisors can accomplish the following:

• Build and manage portfolios more in line with how people actually think about their money
• Build portfolios that remain quantitatively sound but are more aligned with client objectives
• Allow for more-intuitive thematic allocations to active management, illiquid holdings, operating companies, insurance, and so forth
• Provide better transparency into the cost of protection/insurance/safety
• Engage in better/deeper conversations about the purposes of the client’s wealth and how portfolios are designed and managed to serve those purposes

In an era of democratization, commoditization, and disintermediation, advisors need to develop a differentiated personal and practice brand and deliver an enhanced overall client experience.

Adopting a goals-based wealth management approach is a great way to start.

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Endnotes
1. There is a discussion to be had about whether it is people who are irrational or whether the theory that assumes perfect rationality is fundamentally flawed, but that discussion is beyond the scope of this article.
3. See Reichheld (2003). The business management tool “net promoter score” is based on a similar belief in the power of driving client advocacy.
4. Please don’t run or back test my numbers—I made them up. That is not the point of this thought experiment.
5. See, e.g., Chhibra et al. (2008), Brunel (2011), and Das et al. (2011).

References

Note: The views and opinions expressed in this article are solely those of the author, and may or may not reflect the views of Dynasty Financial Partners.