

INVESTING & WEALTH



CFA SINGAPORE INSIGHTS

By Giuseppe Balocchi

Goal-based investing: Should it be the norm?

Investment professionals who put their clients' goals front and centre help spell out their mission and purpose

TO PARAPHRASE Richard Thaler, all finance is behavioural. In the same spirit, all investment management should be goals-based. After all, both institutional and private investors hold assets to meet their liabilities and achieve their financial objectives. These are, or at least should be, the client's goals. By focusing on them, the investment profession can define its mission and purpose, just as Charles Ellis, CFA, so eloquently articulated in *The Winner's Game*.

When discussing goals-based investing, the recent study *Investment Firm of the Future* from CFA Institute states the following: "Desire from end investors for investment products and services that deliver client-friendly outcomes has grown."

This is a clarion call for investment professionals to design investment plans that meet investor needs and achieve unique client-directed results.

I believe any investment process should have as its foundation a holistic, in-depth and detailed analysis of the client's liabilities and objectives. What will they owe, and what do they want to accomplish? This is the hallmark of goals-based investing.

Comparing the merits of different approaches or product designs is beside the point. What matters is the focus on the individual client, not generating superior returns, especially in the short term. Portfolios built from beta and alpha components – often by bringing together asset allocation and manager selection – have not served end investors well because they do not directly relate to their objectives.

Multiple time horizons

Based on reasonable return expectations in capital markets, goals-based investing allocates assets to meet these financial objectives and addresses the liabilities over multiple time horizons. If there is no feasible way to meet these targets, then it may be necessary to adjust ambitions downward or increase available assets, whether through additional savings in the case of a private individual or increasing contributions in the case of a pension fund. In this context, risk is easily discussed without complex mathematics.

Risk simply materialises when assets are insufficient to meet the goals, resulting in a shortfall. An obvious but painful and unfortunately rather common example is retirement risk, when retirees outspend their nest eggs.

Effective goals-based investing requires a deep understanding of clients. This provides a sound basis for the adviser/client relationship. Clients are not likely to be disappointed over the long term when they are not promised superior returns and won't rely on them to achieve their objectives. If they end up beating the market, so much the better, but that's the icing on the cake rather than the primary value proposition.

Benjamin Graham's words of wisdom come to my mind: "If the reason people invest is to make money, then in seeking advice they are asking others to tell them how to make money. That idea has some element of naivete. Businessmen seek professional advice on various elements of their business, but they do not expect to be told how to make a profit. That is their own bailiwick. When they, or non-business people, rely on



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others to make investment profits for them, they are expecting a kind of result for which there is no true counterpart in ordinary business affairs.

"If we assume that there are normal or standard income results to be obtained from investing money in securities, then the role of the adviser can be more readily established. He will use his superior training and experience to protect his clients against mistakes and to make sure that they obtain the results to which their money is entitled.

"It is when the investor demands more than an average return on his money, or when his adviser undertakes to do better for him, that the question arises whether more is being asked or promised than is likely to be delivered."

Financial objectives are not achieved simply by beating the market. In the aggregate, this is just mathematically impossible. Targets can be missed despite outperformance when the client's costs and objectives are not fully understood, and the client is not protected against mistakes.

To me and my clients, this is all common sense. But finance as it is practised today doesn't see it that way.

There are a number of reasons for this. The silo structure of financial intermediation makes achieving that holistic understanding of the client's assets, liabilities, and financial objectives difficult. Institutional investors often have complex governance structures with many agents and with asset managers often confined to narrow mandates. Private clients rarely receive such personalised advice, especially when they're not ultra-high-net-worth. The cost of providing advice and a compensation structure often based on transaction costs and product sales makes this impractical.

Short-termism is another impediment. Financial professionals need to manage career risk by focusing on the next quarter or two rather than the next half-century. Compliance requirements can also sow mistrust between private clients and their financial firms. Wealthy private clients with global footprints may just diversify among different financial firms without fully disclosing their wealth and circumstances to any of them. Why? Because they know their conversations with investment advisers are not protected by attorney/client privilege or any other safeguard.

All of the above, together with the innate, deeply human over-confidence bias in decision-making under uncertainty creates misplaced priorities. Beating the markets, especially over the short term, is the focus rather than the long-term objectives. The careful crafting of stories, what I call "narrativity bias" and the marketing thereof, can make financial institutions look clever but, more often than not, delivers no real value to their clients.

Lasting value proposition

But there is hope. First, goals-based investing can create a lasting value proposition – if both financial firms and clients have the courage to break out of the established, largely faulty models. Asset owners with limited institutional constraints – such as family offices and ultra-high-net-worth individuals – are very well placed to accomplish this.

Second, robo advising and other technology, at their most sophisticated, should make it possible to focus on clients' objectives and model them reliably and affordably, even for those with modest wealth.

After all, the approaches developed decades ago – Markowitz's mean-variance optimisation, among them – relied on simplified assumptions and lacked the technology to thoroughly simulate and visualise outcomes. But now we have that technology. It is cheap and widely available. We have enormous computing power, large data sets, and data visualisation capabilities that were the realm of science fiction a few decades ago. We don't need to operate under decades-old assumptions and constraints. We can chart the potential outcomes for clients and gauge their risk aversion instead of making difficult assumptions based on utility functions.

There are caveats, however: Big data and increasing computing capabilities can lull us into over-confidence, but the future is at least as uncertain as it ever was. Judgment and professional scepticism are vital today, just as they were in the past.

It is a brave new world. But it is one well worth embracing – for the benefit of our clients and to create and sustain a meaningful mission for the investment profession.

☞ Giuseppe Balocchi, CFA, is passionate about bridging the gap between the theory and the practice of finance with a pragmatic, multi-disciplinary approach. He is a partner with Alpha Governance Partners and specialises in derivative strategies. Dr Balocchi serves on a number of company and investment fund boards and is a member of the Future of Finance Content Council of CFA Institute.