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Why choose goals-based investing over traditional passive asset allocation?

For decades, investment and financial advisors have applied the principles of modern portfolio theory (MPT), the capital asset pricing model (CAPM), and the efficient frontier theory when constructing client portfolios. These principles were largely based on the work of American economist Harry Markowitz, who wrote an article titled "Portfolio Selection" in 1952, published in the Journal of Finance. That paper laid out the mathematical arguments in favor of portfolio diversification. Markowitz later shared the Nobel Prize in Economics in 1990 with two other scholars "for their pioneering work in the theory of financial economics."

MPT theory retains strong advocates, and it generally served investors well during the last few decades of the 20th century. Investopedia says, "Modern portfolio theory has had a marked impact on how investors perceive risk, return, and portfolio management. The theory demonstrates that portfolio diversification can reduce investment risk."

There is little doubt that focusing on the relationship of risk and return was, and is, a compelling and positive tool for investors and their advisors as they consider investment options. Efficient frontier theory took this to a new conceptual level, identifying "the portfolio composition(s) that provide one with the maximum return for a given degree of risk or, alternatively, the least amount of risk for a given return" (efficientfrontier.com).

On a theoretical level, this sounds vastly superior to selecting investment vehicles and portfolio composition with little regard to risk. And it is. MPT and efficient frontier theory still have valuable roles to play in examining portfolio alternatives.

But the broad and deep market downturns of the 21st century exposed some serious weaknesses in the theory of classic asset-allocation strategies and MPT, especially as they relied on a passive approach to investing. Advisors and their clients witnessed several "real-world" effects on markets and investor behavior in times of severe stress, such as that seen during the dot-com meltdown and the more recent credit crisis:

- MPT/efficient frontier theory was severely challenged by traditional asset-class correlations not behaving as expected, which was explored in Proactive Advisor Magazine's article, "A more efficient (and profitable) frontier." That article examined one of the key underpinnings of efficient frontier theory, concluding, *"The efficient frontier was wildly different for every 10-year period from 1950 to 2009 (and this inconsistency persisted from 2010 to 2014). What that means is using any period of historical asset-class returns to create an optimal portfolio for the following 10 or 20 years is, at best, unreliable."*

- The "sequence-of-returns" dilemma undermines even very capable application of MPT for client accounts. As numerous studies have shown, when clients are in the distribution phase of retirement, the sequencing of their investment returns can have disastrous effects on the long-term viability of generating an income stream. Put simply, two portfolios may have the exact same "average return" over a 20- or 30-year period, but the timing of those returns can mean the difference between building a very comfortable retirement trajectory and simply running out of money.

- Classic passive asset allocation according to MPT, while perhaps "maximizing" return relative to risk, does not mean risk is totally mitigated. As one experienced financial advisor told Proactive Advisor Magazine, "I was a firm believer in modern portfolio theory up until the financial crisis of 2008–09. I always thought it was sufficient to have client portfolios that were optimized as much as possible for risk and return. However, while a portfolio might beat the worst of the market's performance in a severe crash, it is still unacceptable to see portfolio declines of over 20% or 30%."

- To the point above, the most troubling aspects of client behavior can surface when markets crash—despite having "well-constructed" portfolios. The herding mentality can come to the forefront when investors perceive "the investment world is coming to an end," and emotional panic dominates decision-making. In their 2015 book "Applied Asset and Risk Management," authors Marcus Schulmerich, Yves-Michel Leporcher, and Ching-Hwa Eu had this to say in their chapter "Modern Portfolio Theory and Its Problems":

"Moreover, traditional finance theory cannot explain market situations like crashes and stock market anomalies. … The global financial crisis caused many to reexamine practices in the finance industry and to wonder if there had been too strict an adherence to theoretical concepts at the expense of a more pragmatic or practical viewpoint."

Many financial advisors have not needed a deep and well-researched academic analysis to come to these very same conclusions, looking for new solutions for clients' long-term investment plans. A good portion of these advisors have turned to a combination of "goals-based investing" and outsourced investment management, using managers who provide more active and risk-mitigating strategies.

<u>What are the broad objectives of goals-based investing?</u>

It is perhaps easiest to start with what goals-based investing is not. It is not an investment plan that seeks to duplicate broad market results or build comparisons to popular market benchmarks.

It starts with a financial plan that attempts to identify realistic levels of returns that will help a client meet their financial goals, typically beginning with the most fundamental goal of generating adequate income (along with other sources) in retirement.

By its very nature, a goals-based investment plan will not see returns anywhere near those of the best bull markets. But, importantly, it should also not suffer the worst drawdowns seen in severe bear markets. In general, the objectives of a goals-based investment plan are to smooth out volatility, achieve steadier returns, and project a range of returns for a client that is consistent with their risk profile and has a reasonably strong mathematical probability for success over time.

In very simple terms, if a client requires returns from an investment plan (with all other factors being considered) that average 4% over time, a goals-based investment plan might target an expected annual range of 2%–8%. Will there be outlier years to both the upside and downside? Of course. But the goal is to minimize their frequency and their severity, and manage risk such that portfolio drawdowns are consistent with an investor's risk tolerance.

By incorporating goals-based strategies we are able to better tailor investment approaches to meet clients' specific needs and desires. Combined with the behavioral finance benefits of this process, clients are more likely to have realistic and achievable expectations, enabling them to stay the course to meet—or even exceed—their stated goals.

CNBC recently quoted Ashvin Chhabra, former chief investment officer at Merrill Lynch Wealth Management and author of the book, "The Aspirational Investor: Taming the Markets to Achieve Your Life's Goals." Said Mr. Chhabra, "At the end of your life, saying 'I beat the S&P by 3 percent' doesn't mean anything. But if you say, 'I invested well, I had a nice house, my kids went to a good school,' that's something."

As always, if you have any additional questions please do not hesitate to get in contact.

Sincerely,

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