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Goals-based Investing Goes Mainstream?

- An unprecedented period of market volatility, including the collapse of financial institutions and a meltdown of the mortgage and housing markets has caused many investors to heighten their focus on personal investment goals.
- In response, many investors and financial services firms are looking to redefine their investment strategies.
- Goals-based investing is emerging as an increasingly attractive approach.

For the most part, the financial services industry has been slow to embrace the principles of behavioral finance and apply them to investment solutions. Target-date funds, which were introduced in the 1990s and proliferated during the following decade, were an entry-level foray into goals-based investing. Today, the financial services industry appears to be in the midst of taking another step in the evolutionary process.

Industry "Big Guns" Recognize the Strategy

In May 2013, Merrill Lynch hired a new chief investment officer as part of the firm's effort to shift to a goals-based advisory initiative. This followed the framework set forth in the its 2011 whitepaper entitled "The Wealth Allocation Framework Revisited," which explores a so-called "new" approach to managing client wealth in response to the financial crisis. The "Framework" incorporates behavioral finance in an investment approach, with the objective to "maximize the probability of achieving a clearly defined set of goals."

Vanguard's rhetoric has also been moving in a goals-based direction. In July 2013, the company's website featured an article entitled "Turning financial goals into reality." The commentary noted that, in addition to retirement planning, goals-based investing "…can work for life's other big financial goals—college, a wedding, buying a house."

The firm has mentioned the concept in the past. Notably, in 2007, Vanguard entered the goals-based fray, in response to the notion that target-date funds lacked meaningful measures to assess progress toward achieving goals. (At the time, target-date funds were one of the fastest growing segments of the mutual fund industry.) In a paper entitled "Target Date Funds and Goal-Based Benchmarks," the firm eschewed the short-term focus of benchmarks being used to measure the success of target-date funds. It proposed instead to measure goals-based benchmarks designed to better assess target-date fund performance as it relates to investor goal achievement.

Why Goals-based Now?

Coming out of the "Great Recession," investors want to know how to navigate an ever-changing investment landscape in a world where there's a new crisis on every horizon. Investors are looking for assistance in defining their unique personal financial goals and are seeking strategies designed to help get them there. Such needs are a far cry from product-only sales that entail a cookie-cutter approach and often ignore the fact that all investors are different. In building a portfolio to meet their unique needs, they are less likely to concentrate on portfolio returns in relation to a benchmark and more likely to focus on how they will meet their many financial objectives (including saving for retirement, obtaining a vacation home, saving for their children's education or providing for shorter term liquidity needs). Their financial needs and desires are germane to their situation alone. When viewed from this perspective, an investor's tolerance for risk cannot be defined simply by age, years to retirement or station in life.

The growing recognition of goals-based investing as an imperative approach is a huge shift for an industry that has historically lacked strength in giving personal advice or sustaining ongoing relationships with investors.

Going Back to the Future

While the financial industry grapples with this so-called new approach, SEI has been on the cutting edge of goals-based investment strategies since 2003. After publishing a groundbreaking paper entitled "Goals-based Investing: Integrating Traditional and Behavioral Finance" in October 2003, we put our research into practice, with the introduction of our first goals-based strategies on November 30 of that same year.

In doing so, we extended our goals-based investing approach, from simply segregating pools of assets by client goals, to creating investment portfolios that align with how investors actually view risk. This was a significant shift away from modern portfolio theory.

Modern Portfolio Theory: Markowitz

In his 1952 paper, Harry Markowitz told us that a portfolio manager's goal is to manage the tradeoff between risk and its expected return, and build portfolios that maximize returns for a given level of risk. Markowitz's work formed the basis for modern portfolio theory, which helps investors make efficient portfolio selections within their risk tolerances.

Of course, this approach has been put to the test on multiple occasions since the 1950s, and while several aspects of it are sound, it failed to recognize that investors are often irrational. This needed to be addressed.

The Study of Behavioral Finance

In 2002, Professor Daniel Kahneman, of Princeton University, won the Nobel Prize for Economics, based on his work in the area of behavioral finance. Kahneman and others put modern portfolio theory to task by studying how investors actually think and behave, rather than how financial theories and theorists suggest they should behave. The study of behavioral finance has challenged the very foundation of modern portfolio theory, for once abandoning the assumption that investors are always rational.

The work of Kahneman and others, such as behavioral theorists Nicholas Barberis and Richard Thaler, helped form the basis for a new approach that is focused more on achieving investors' specific financial goals.

Unlike modern portfolio theory, the study of behavioral finance can help explain why many investors tend to buy high and sell low, why they tend to become greedy when markets are approaching a top, and why they become fearful when markets are at or near low points.

Redefining the Investment Approach

SEI's work in this area led to a belief that not all investors make decisions based on the tradeoff between risk (standard deviation) and return. Aggressive investors, or those with long time horizons, may desire a portfolio with risk defined relative to broad equity and fixed-income markets—electing a point along an efficient frontier to capture the returns of equity and credit. However, a more conservative investor, or one with a more time-sensitive goal, may not want always to assume the full risk of global equity and fixed-income markets. This investor's concept of risk is a one-way street (unlike standard deviation), with the emphasis on the downside. More conservative investors view risk in terms of how much money can be lost. Risk, in this sense, is more absolute than relative. SEI's goals-based investment strategies were designed to account for such differing needs and views of risk.

The underpinnings of goals-based investing rest in redefining investment objectives. Rather than using measures of return and standard deviation to define success, results are instead measured in terms of the investor's ability to meet personal financial goals. Risk is viewed in terms of the probability of falling short of those goals, as opposed to simply outperforming or underperforming a benchmark index.

Goals-based investing is a more intuitive approach for investors because it centers on meeting tangible objectives. The focus changes from exceeding the return of a given benchmark to achieving the tangible. Reliance on returns to measure success and standard deviation (a term few investors comprehend) to measure risk is replaced with the pursuit of specific and personal goals. A portfolio solution tailored to better align with an investor's view of a goal and measure of risk becomes more easily understood and relevant, leading to more meaningful, personal discussions of wealth management.

Because goals-based investing incorporates the principles of behavioral finance, it can help change investor behavior by creating a more rational framework for expectations. It can also help investors avoid traditional mistakes, such as making snap decisions to pull out of the markets during volatile periods. When the focus is on a particular financial goal, and not on a benchmark return, investors may be more likely to ignore the many whims of the market.

SEI at the Forefront of Goals-based Investing

While SEI was an early proponent and early adopter of goals-based investing, we did not completely dismiss modern portfolio theory. Instead, we stated that traditional financial theory and behavioral finance need not be an all-or-nothing proposition; there is value in both approaches. This mindset is reflected in all of our goals-based offerings—launched in 2003 for the U.S., in 2010 in for the U.K. and in 2012 for Canada.

However, the long-held industry practice of aggregating all client financial assets into a single portfolio, and then measuring the success of that portfolio relative to a given benchmark, was replaced by a more focused approach. Since investors have multiple financial objectives with differing time horizons that have varying degrees of importance, financial assets are instead broken out in separate portfolios, specifically designed to meet an individual goal. In this context, the measure of risk that guides our allocation process will vary across our portfolios, as we view risk as relative to the ultimate goal. With the tenth anniversary of SEI's first goals-based offering getting closer, we are pleased to remain at the forefront of this not-so-new type of investing—delivering practical strategies to help investors achieve their personal financial objectives.

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