What is goals-based advice?

The concept of goals-based advice places clients' personal and lifestyle goals at the core of the financial advice process, incorporating an appropriate level of investment risk and determining whether the outcomes can realistically be met. Goals-based advice is a departure from the traditional modern portfolio theory approach which applies risk/return principles with a focus on maximising returns rather than meeting client lifestyle objectives.

Adviser/client tensions during the 2008 Global Financial Crisis, elevated client risk aversion, tighter compliance standards under the FOFA regime and more recently, highly publicised scandals involving financial advisers and the push for higher professional standards, have highlighted the need for a more client-centric approach to the financial advice process. A rapidly aging Australian population, eager to meet retirement investment goals has also created greater relevance for goals-based advice for retail clients.

Goals-based advice can be a difficult to conceptualise as most financial advisers would undoubtedly argue that they already place client objectives at the forefront of the advice process. But what does this actually mean in practice?

How can a scalable model be implemented that is agile enough to service the individual financial and lifestyle goals of a broad cross-section of clients?

Director at WLM Financial Services, Dynamic Asset Consulting and Chairman of the Association of Goals Based Advice (AGBA), Matthew Walker, explained that the key to understanding goals-based advice was to move beyond the idea that all financial advisers were goals-based advisers to looking at what the reality of the label actually meant and how the concept was implemented.

"A large part of the difference is going to come out of the investment philosophy and how you manage the investments," he said. "An old statistic thrown around from many surveys is that most clients, about 70% of clients, think of financial planners as investment advisers, so that's obviously a large part of the value proposition of the industry.

"I think we can change that perception to be more strategic, which is more genuine financial planning than product and investment. But if you have a look at the steps required, really what you need to determine is what is your investment philosophy and how do you believe you should manage money?

The degree of difficulty in communicating a shift to the goals-based advice model to clients will depend upon how different it is to the existing advice framework of the business. Many clients, particularly older clients, may be averse to changes in value propositions.

Walker suggested that advisers should seek to thoroughly understand the philosophy of goals-based advice and get to a point where they feel comfortable advancing that philosophy. Also, be able to frame client conversations in a way that demonstrates a greater empathy and understanding for their wants and needs.

“Change management is never easy in any business,” he said. “First of all, is to have a conversation with a client saying, ‘We’re moving from approach A to approach B’. They might not be that far away [from your ideas] but there’s a bit of a nuance in the conversation. You do have to think through the practical aspects of how to communicate with your client, what you’re putting in a statement of advice (SOA) and how you’re reporting on those elements.”

Head of technical services at Challenger, Andrew Lowe, highlighted the importance of also considering internal stakeholders in change-management strategy planning.

“Bringing stakeholders along for the journey is critical in terms of the success of implementing this particular process, and that’s all stakeholders from support staff, para-planners, advice technology solutions and sometimes even compliance professionals associated with it,” he said.

Walker noted that there was a considerable amount of education required on goals-based investing for the advice community and regulators.

“We had to educate trustees as to why that was going to be relevant to our investors over and above a balanced risk profile,” he said. There’s a high-level status quo hurdle to overcome. It’s an education and awareness type thing. IFA’s are well positioned to take the lead on this insofar as they run their own businesses, they generally have their own licenses and they can really change quickly as opposed to some of the larger institutions that will have a number of different things they need to consider.

“It comes back to a mindset. Why are we doing things? How are we doing it? What do we want to deliver to our investors and then what you need at a practical level to do it? You’re going to have a whole checklist of things to get through.

Walker added that a primary challenge for financial advisers in implementing a goals-based model into their practices was gaining approval from their dealer group.

“We have a very high proportion of individual planners that we speak to who want to adopt a goals-based approach,” he said. “One of the more common hurdles we run into is not the systems, the processes, the technology or anything like that, it is their licence.

“We often get authorised representatives of larger dealer groups who say, ‘I love this approach. What can I do?’ and you say, ‘Well, you need to talk to your dealer group and get them to approve this particular approach’.

“That might be you doing it yourself or it might be another product to put on an APL. We’ve seen a bit of a migration of advisers coming out of the larger banks, insurance companies and so forth to pick up their own license because they genuinely want to provide good goals-based advice and solutions to their clients.”

“Some groups are providing solutions for goals-based investing. The most common of is inflation plus or CPI plus. Usually it three or five percent where most of the institutions seem to be landing. There are some that are doing liability-based strategies and some are doing risk management. There’s not a lot that are doing the whole lot in a single offering. You've also got financial planning groups that have developed white-label solutions for their clients."

Deeper levels of client engagement

The process of goals-based provides an extra dimension to the advice process which helps shift the focus away from product and creates a deeper level of client engagement. Walker noted that discussing goals and aspirations naturally creates a rapport between adviser and client.

"You get better business out of that," he said. "The clients focused less on product. They're focused more on outcomes. They are likely to be happier. They're likely to refer more. You're likely to get less enquiries because the advice provided is not necessarily just about a product.

"So, if the market doesn't perform the way you want, it's not as relevant because they still understand what their goals are, so it brings it back to a real conversation."

Lowe added that the goals-based advice process also shifts the client's attention to a place where the adviser can directly display their knowledge and expertise.

"With goals-based advice, the client focus is much more clearly on what advisers can control as well and that's particularly helpful," he said. "It's less focused on some of the "uncontrollable" like day-to-day movements in investment markets and so on."

Common financial goals

Financial goals are very much an individual prospect for clients. Most would have goals at some time in their lives that include buying a house, perhaps an investment property, overseas travel and funding their children's education. Lowe, explained that as clients age, goals tend to focus more on areas such as financial security and mitigating longevity risk.

"We undertook some research recently with National Seniors Australia," he said. "We surveyed more than 5,700 senior Australians. They responded to questions about things like their health, social wellbeing, finance, work and ultimately retirement. The findings really strongly aligned with what advisers tell me the goals of their retiree clients look like. Some of the areas that senior Australians rated as very important were:

- Regular constant income that covers essential needs (84% of respondents)
- Ensuring that money lasts for a lifetime (77%)
- Being able to afford aged care and medical costs (71%)
- Savings that can be withdrawn as needed (65%)
- An income that adjusts for inflation (63%).

"The prospect of life on the age pension plus a bit looks more attractive than life on the age pension alone and that extra bit might be $1,000 a year, it might be $5,000, $10,000 or more.

“It need not be the ASFA comfortable standard of retirement, for example, but certainly that ability to have extra income throughout retirement is a really important goal for clients such that they can meet their essential spending.”

Lowe added that bequests to family rated much lower than he had anticipated. “For me, there were some surprises in that research as well,” he said. “Leaving the family home to children rated quite lowly at just 26% of those surveyed. Twenty three percent were interested in leaving assets or investments other than the home to children, so bequest also interest rated quite lowly.”

The goals-based advice process

There are a number of approaches to the practice of goals based advice but the consensus among practitioners is that the first logical step is prioritisation of goals. Walker explained that when prioritising goals with clients, advisers should address the three main elements of an investment outcome: time horizon, rate of return and risk profile.

“Is it a short-term, mid-term or long-term approach? Another consideration is the rate of return you’re looking for. Are you looking for a 2% rate of return, 3% rate of return, 5, 10 or whatever it may be? The other one is risk, so how much risk are you prepared to take?

For example, funding a child’s secondary education may be a high priority but if the child is only two years old the goal may be assigned a more aggressive investment strategy than another with a shorter time horizon such as renovating the family home.

Walker added that prioritisation of goals can become more complicated when a client’s time horizon, rate of return and risk profile are in major conflict.

“For example, ‘I want a high rate of return but I don’t want to take any risk’,” he said. “So, you then need to be able to figure out how each investor’s goals meet with those risk tolerances. Discuss what’s of most importance to them, discuss what they’re comfortable with and what they’re willing to accept in order to be able to get something that sits within their risk profile and meets their needs.

Lowe noted that client age should also be a key consideration when prioritising goals.

“The goals of a client at 65 are different from those at 75 and certainly different from those at 85 and beyond… all requiring this uncovering and prioritisation,” he said. “It’s matching those goals to the costings of the particular goals, and depending on the client… they might be as broad as income needs, income wants and legacies or they might be far more granular in nature.

“This is quite different from an approach which might start with the client’s accumulated retirement assets, from which a safe level of spending is drawn and budgeted and accounted for. It’s this difference that is key to goals-based advice.

Implementation of strategies for each goal

Following on from the prioritisation of client goals is the implementation of strategies for each goal. Lowe explained that applying strategies to each goal ensures adequate capital is allocated towards achieving them.

“An area absolutely critical to this process is applying an investment strategy to each of the goals - prioritising those high priority goals and ensuring that they’re properly funded before we move on to lower priority goals for particular individuals,” he said. “The priorities really do ensure that we’ve got cash flow to meet those essential spending needs as they’re required. We match investment assets to those goals and we ensure that the risks are matched to the cash flow characteristics and they’re comparable.

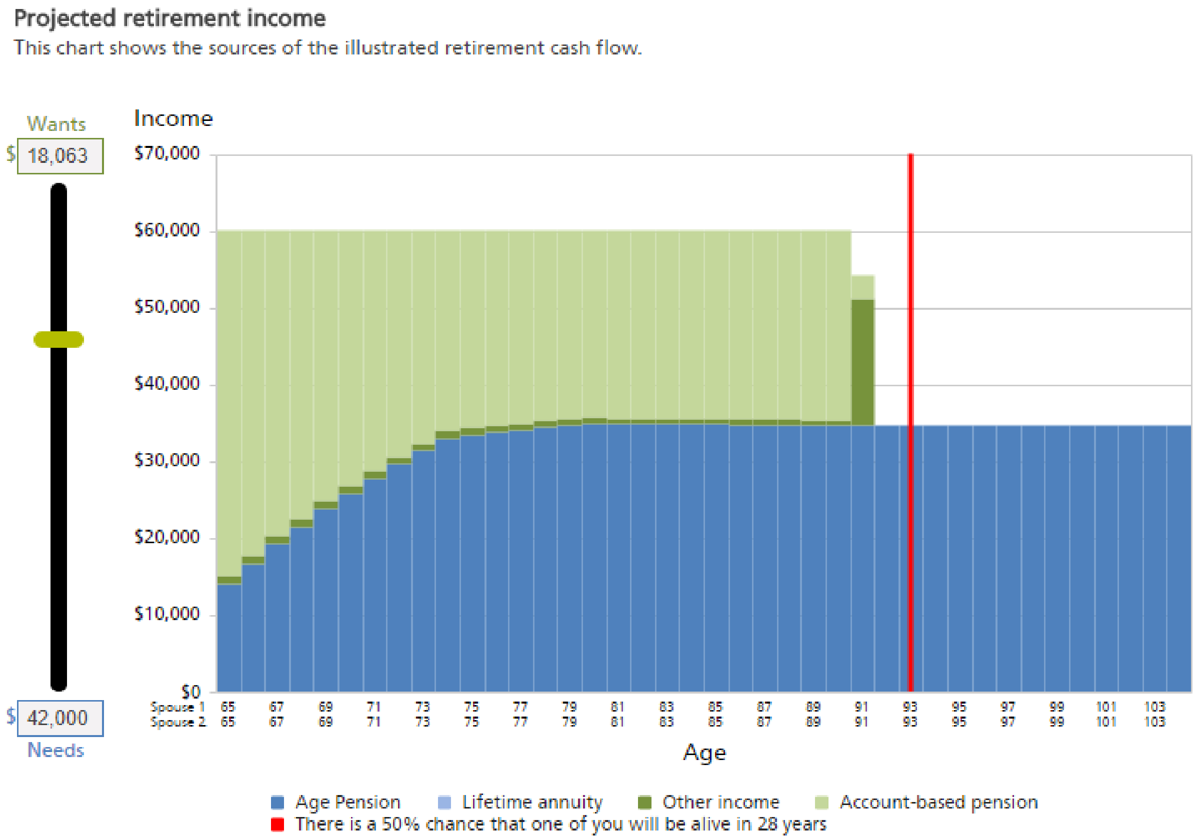
“So, for example, we may use income from the age pension and from a highly secure investment like a lifetime annuity to meet the income “needs” of a client. We then may satisfy the income ‘wants’ and legacy intentions of the client with other investments, say a balance of growth and defensive assets held via a structure like an account based pension.”

CASE STUDY - NEEDS VERSUS WANTS

Walt White and his wife Wendy White are both aged 65. They are balanced (50/50) investors, using a traditional risk profile.

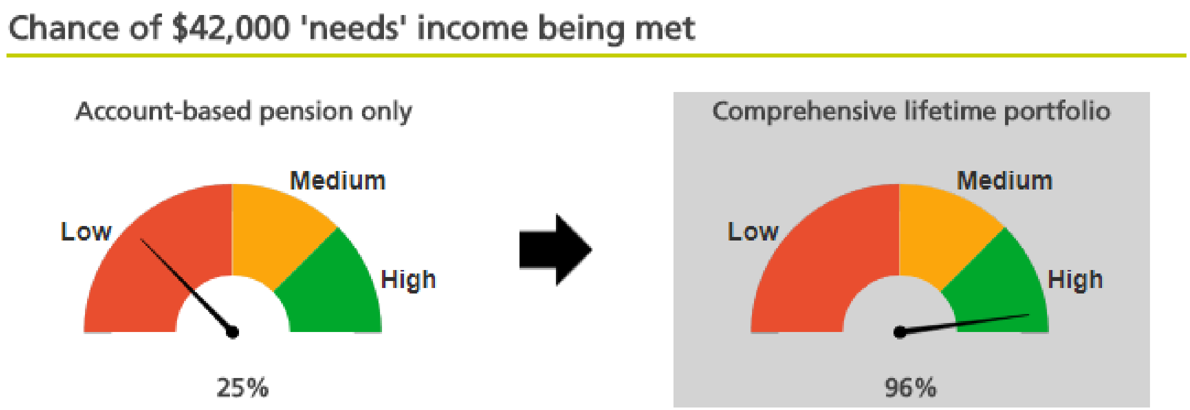
Walt and Wendy need $42,000 p.a. for life to meet their retirement income “needs” but “want” $60,063 p.a. (equal to the ASFA comfortable level of income).

Their financial adviser employed a “retirement illustrator” to show that if they employed a traditional approach (using a balanced portfolio via an account-based pension) they would be risk of depleting their capital completely in retirement. Importantly, from a goals-based advice perspective, Walt and Wendy would have failed to meet their most important retirement goal (income to meet their needs0 because the maximum rate of age pension is less than their income needs.



Stochastic modelling showed that in 2,000 modelled scenarios, Walt and Wendy's income needs were met (out to the time at which there is a 50% chance that one of the couple is still alive) 25% of the time. A 75% failure rate on these client's most important retirement goal is unlikely to go over well with most clients.

If, instead, Walt and Wendy's income "needs" were met with a combination of age pension and guaranteed income (in this case using a combination of lifetime annuities with 30% of the investible assets) the 25% success rate would increase dramatically to increase to 96%.



Source: Challenger

Walker reiterated the importance of building flexibility into the strategy or investment portfolio for goals-based advice.

"If you're trying to achieve a specific rate of return then really what you need is to be flexible with where you invest," he said. "You can't back yourself into a corner by saying, 'This is my SAA position come hell or high water' because we all know the world changes and these days it changes rapidly.

"So, whether you're in shares or out of shares or whatever, you need the flexibility to be able to… be dynamic. You can't just sit there and let the bus run over you. So, it's important to have a flexible asset allocation range."

Risk management

The traditional modern portfolio theory approach to financial advice supposes that market volatility is the primary risk to a client and attempts to minimise exposure to it as a primary objective. While the goals-based approach also seeks to minimise the impacts of volatility, the key risk is that a particular goal is not met.

Walker explained that, while risk profiling is a critical component of the goals-based advice process, it is analysed within the context of its impact on goal achievement.

"Risk has been a little bit misconstrued over the years insofar as the general practice has been that you meet with a client, understand their financial situation and get a risk profile," he said.

"From that risk profile, you then allocate them towards being a balanced investor, a growth investor or a conservative investor, whatever it may be. That risk profile analysis is then usually attributed to an asset allocation and ultimately an investment portfolio.

"Unfortunately, that particular approach might not have any relevance whatsoever to what they actually need. It might not meet their goals. It might not achieve their goals. It might be too much. It might be too little. There is really no correlation between how someone feels and what they mathematically need to be able to achieve their stated goals, but it still plays an important part."

Walker laid out how the assessment of risk is typically incorporated into the goals-based advice process.

"We believe that the approach that makes more sense for the client themselves and for a financial planning business is to meet with the clients, find out what their situation is, find out what they want, understand their risk profile but then do an analysis on what exactly they need to do to be able to meet their goals," he said.

"So, do you need a specific rate of return to be able to get a bucket of money of $X at retirement, whatever it may be or have money available in two years to fund renovations or school fees for kids and so forth?

"It really depends on what you're looking to do but, fundamentally, you need to say, 'Okay, this is your goal. This is the appropriate investment to meet that goal' and then have a look at whether or not it fits within the risk profile. Risk profiles should be at the back end of the process and not the start of the process."

Lowe highlighted the importance of not allowing a client's risk appetite to be affected by the security around some of their highly prioritised goals.

"When we put in place some certainty around meeting the highly prioritised goals of a particular client, that may impact a client's willingness to expose their lower priority goals to different levels of risk," he said.

Conclusion

When prioritising client goals, it is prudent for advisers to ensure that three main considerations are addressed: time horizon, risk profile and rate of return.

Once these are established, funds can be allocated to individual goals to ensure the goals are achieved according to the priority communicated by the client.