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Why goals-based investing enhances modern portfolio theory

Modern portfolio theory might have served investors well when most were in accumulation phase but advisers need to focus on goals-based investing as more clients move into retirement, Jeff Rogers writes.

Clients and their advisers once considered a single financial objective: to maximise portfolio returns subject to an acceptable level of volatility. The textbook modern portfolio theory (MPT) approach served that purpose quite well because most Australians were in the accumulation phase of investing.

But seminal events and societal trends, including a surge in the number of retirees with multiple goals of differing importance, have exposed the limitations of that approach in some important circumstances. MPT, with its focus on markets and managers, is a world away from helping manage customer expectations along the investment journey.

The shortcomings of the MPT approach in these circumstances has, therefore, led to the emergence of a goals-based approach to investing that is delivering more confidence and greater contentment to an important cohort of clients.

REALLY 'RATIONAL'?

The first major challenge to the traditional MPT approach was questioning the applicability of a key assumption around how individuals compare investment choices; in particular the relative importance they place on the risk of disappointing outcomes.

Through his work on behavioural economics Daniel Kahneman showed that, far from conforming to textbook assumptions around “rational” trade-offs in decision-making under uncertainty, investors were guided and sometimes blinded by various inherent biases.

THE GFC

The next big challenge to the MPT approach was the searing experience of the Global Financial Crisis (GFC). Portfolios were diversified, as the theory advised, but assets that were meant to diversify fell in lockstep.

Granted that those were exceptional times, but the GFC did highlight that advisers and their clients were not well-equipped to work out how to react to hanging conditions. MPT didn't offer a simple but prudent process to guide a strategic response as events unfolded. Should clients go to cash? Should they grit their teeth and cut their spending? If so, then how much belt tightening was appropriate?

BABY BOOMER BULGE

But the major challenge facing the traditional investment approach is the emergence of a demographic bulge of Baby Boomers – both in Australia and around the world – moving into retirement.

It became clear that the underlying investment goals of these retirees were significantly different from those in accumulation. Their asset portfolio needed to help fund their consumption. They needed a consistent reliable income; but they also had other spending goals: an overseas trip, a renovation, the desire to leave bequests to children and grandchildren.

The financial strategies for these retirees had to address several risks unique to their circumstances: the risk of outliving their savings (longevity risk); the risk of material impairment to their assets at the beginning of retirement (sequencing risk); as well as the risk of events such as an unexpected rise in inflation that could erode their purchasing power.

The traditional MPT approach, which based success on risk-adjusted return on investment, was detached from investors' and clients' goals, and was not designed for those in decumulation with multiple goals. Fund managers were focused on conditions in the market and maximising returns. By design they were insulated from the unique circumstances of their clients and investors.

A DIFFERENT APPROACH

These challenges required a new solution, and the solution that emerged has been goals-based investing.

The goals-based approach reverses the order of decision-making relative to that adopted in the traditional MPT approach. The goals-based approach first identifies personal and lifestyle goals. It prioritises these goals. Only then does the focus turn to designing strategies aimed at maximising the chances of reaching those goals.

Goals-based investing doesn't judge success or failure by measures such as outperforming or underperforming a benchmark. Failure is about falling short of goals.

A HIERARCHY OF GOALS

Goals-based investing has given clients and advisers, firstly, the ability to better understand and rank goals.

In his 1943 paper 'A Theory of Human Motivation', Abraham Maslow said that as humans our priority is to satisfy fundamental needs related to survival. After those needs are satisfied we can pursue other higher needs such as self-actualisation.

The goals-based approach to investing recognises the most important and fundamental needs relate to essential everyday expenses. They need to be met first. Any shortfall here is

painful. Discretionary and aspirational goals, such as travel and inheritances, are higher up in the hierarchy.

INFORMED STRATEGIES

The goals-based approach has also helped inform the design of investment strategies for clients, particularly those in decumulation.

The traditional fund manager wouldn't, for example, know that a client has just retired and has a lot more exposure to the market now than they would deep into retirement. So, they can't incorporate this information in their strategies.

Retirees need a strategy that helps manage inflation risk; that protects against sequencing risk by carefully managing exposure at the start of retirement and potentially incorporates downside protection, particularly in the first five to 10 years; and they need strategies that help lock in shorter term cash requirements.

CONFIDENT CLIENTS

Perhaps the biggest benefit of goals-based investing is the confidence it gives investors and advisers along their investment journey.

At the height of the GFC many investors and clients threw in the towel, ditched their investment strategy and fled to the siren call of cash. It was the worst possible time to sell. But their decision was understandable: they simply lacked confidence in a strategy that seemed abstract and distant, that wasn't connected to their goals.

Goals-based investing is restoring the confidence lost through that experience. Clients know they have been listened to; their own goals and aspirations have been at the forefront of the advice and investment process; they receive reinforcement that their strategy is designed to weather the rough times and keep them on track.

CONTENTED CLIENTS

When most Australians were in accumulation with one simple goal, MPT served the purpose well. And the focus-on-returns philosophy it spawned still has considerable relevance to the many in accumulation with retirement a long way off.

But as more people moved to retirement, a new paradigm was needed to handle the greater complexity of goals for clients and investors on the cusp of, or in, retirement. Goals-based investing is now meeting that challenge and creating more productive advisers, and more satisfied and happy clients.

About the author

Jeff Rogers joined AMP Capital in 2011 from ipac Securities, following its acquisition by AMP Ltd. He has over 27 years of investment management experience. Jeff holds a Bachelor of Science (Honours) from the University of Melbourne. [You can read his original article here.](#)