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ci collective INSIGHT

INSIGHT INTO SA INVESTING FROM LEADING PROFESSIONALS

GOALS-BASED INVESTING

finweek
MONEY. POWER.

Aligning assets with their owners

The investment industry exists to serve asset owners, for whom retirement is an income challenge, not a return challenge. You can't retire on a good Sharpe Ratio and you can't eat alpha. And unlike the maximisation of returns, a defined goal in the form of an income target is both achievable and controllable, which makes it much more suitable as an anchor for an investment process.

Using goals as a reference point for success would make for some interesting changes compared to a traditional investment process focused on maximising return. What follows is an analysis of four key ideas that will require attention if goals-based investing is to succeed.

INVESTMENT RISK VS SAVINGS RISK

TRADITIONAL RISK-PROFILING techniques are still defining risk based on return metrics and not with reference to annuitisation. In a 2014 study on how savers think about risk, the Pensions Institute at CASS business school in the UK found that while traditional risk-profiling questionnaires accurately captured attitudes towards investment risk, they were thoroughly inconsistent in terms of defining clients' attitudes towards savings risk; clients across the spectrum of Cautious to Adventurous all gave equivalent responses to questions on savings risk.

Is it prudent to suggest that a client has a high capacity for investment risk-taking if they are not willing or able to accept a large shortfall of their retirement goals? The study also found a significant amount of "reckless conservatism": only 12% of savers disagreed that missing their savings goals was more acceptable than taking investment risk. If we define risk as the likelihood of falling short of that income replacement target, then it follows that risk attitudes should be determined by a client's flexibility on the magnitude of shortfall.

CONTROL AND ACCOUNTABILITY

ASSET OWNERS DELEGATE to advisers who delegate to fund managers who ultimately leave the capital with company management. With this level of intermediation it is impossible for the ultimate asset owner to attribute accountability on a returns basis. Emphasising outcome-based selection criteria such as "the number of previous clients an adviser has helped achieved their goals" is a more relevant measure of investment success. Compensation on this basis will also better align interests in terms of reducing costs and incentivise asset retention over asset gathering for fiduciaries.

For the large majority of savers, the most significant factors determining investment success are their savings rate, how long they work until retirement and their future retirement spending – all of which are normally within a client's control. This will shift the emphasis of accountability for reaching their goals onto their own actions, avoiding over-reliance on investment returns and reducing unnecessary emotional pain from having unrealistic expectations of financial markets. Saving more has the direct consequence of increasing your investment pot, whereas taking more investment risk by no means guarantees higher returns.

SHORT-TERMISM

WEALTH ACCUMULATION IS a multi-year and often multi-decade process. Basing decision-making on a long-term goal can remove the unwanted side effects of investor short-termism. While it is not a secret that the majority of active mutual funds underperform their benchmarks, the annual DALBAR study* has estimated that end investors compounded underperformance through attempting to time entry and exit into the mutual funds:

FROM 1984-2013, THE AVERAGE INVESTOR IN US EQUITY FUNDS ANNUALISED **3.69%** VS **11.11%** FOR THE S&P, A **"BEHAVIOUR GAP"** OF ALMOST

8%

PER ANNUM.

This is particularly significant as the knock-on effects of investor behaviour on the whole economy can be profound. A longer-term focus from asset owners filters through to the behaviour of asset management companies, with less manager turnover and less style drift due to immediate concerns over outflows. In turn, a less transient shareholder base in companies relieves the pressure for corporate short termism at the management level – an NBER survey in 2004 found the majority of corporate management would not proceed with a profitable long-term project if it meant missing consensus earnings forecasts for the quarter! More earnings accretive investments would ultimately lead to better long-term returns for shareholders.

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EMPHASISING OUTCOME-BASED SELECTION CRITERIA SUCH AS 'THE NUMBER OF PREVIOUS CLIENTS AN ADVISER HAS HELPED ACHIEVE THEIR GOALS' IS A MORE RELEVANT MEASURE OF INVESTMENT SUCCESS.

SUBJECTIVE OBJECTIVES

MODERN PORTFOLIO THEORY and efficient frontiers are extremely impersonal (I have yet to come across any wealth manager who finds it practical to quantify each client's utility into indifference curves). This is where many off-the-shelf solutions such as target date funds or 'glidepath' strategies are also not fit for purpose. If you start with high-equity allocations and simply shift to bonds as you age, you will miss out the bulk of potential returns for long-term clients by having investment risk too low when they have the largest amount invested (closer to retirement), thus over a client's lifetime the majority of their assets are invested at too low a risk.

Traditional glidepaths also fail to take into account the personal nature of cash flows. The biggest asset on a young investor's balance sheet is the deferred income of their human capital. For the majority of young professionals, their salary shares similar characteristics to an equity: inflation-linked, vulnerable to a recession, uncertain over the long term.

If the majority of the individual's investment portfolio is also in equities, then tail events such as financial crises and the ensuing unemployment would create the need to cash in savings to substitute for lost salary, a forced liquidity event that ends up with the investor selling out of equities at a cyclical low point. The traditional reasoning that young investors have more 'time to recover' does not take into account these idiosyncrasies in client circumstances and targeting higher volatility in a bid to maximise return would not help this young client meet their objective.

Minimising shortfall risk for this type of young investor would instead suggest allocating to assets less correlated to equities initially and increasing equity exposure to replace the deferred asset of their human capital as it converts to cash over time – another example of how a goals-based approach better aligns a portfolio to its owner's needs.

CONCLUSION

Each investor has their own savings desires and future consumption needs — thus assets under management (AuM) should not be thought of as a total dollar amount but as a collection of the individual goals of every saver underlying those assets. Today the over specialisation at every level of financial intermediation has created a wedge of multiple, divergent incentives between asset owners and their savings. Removing these layers of agency problems requires a structure which aligns managers of capital with the asset owner's ultimate goal — incentives need to be personalised. Compensation based on achievement of client-specific goals (net of fees), including claw-back clauses would provide a much closer alignment of interests than flat management fees. Demand from end-clients for accountability based specifically on reaching their own goals will remove the current 'heads, I win; tails, you lose' dynamic of incentives within investment management, and the rest will follow.

"Never, ever, think about something else when you should be thinking about the power of incentives." — Charlie Munger ■

**DALBAR's 20th Annual Quantitative Analysis of Investor Behaviour 2014.*

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