What is Goals-Based Investing?

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Most individuals are aware of the importance of investing – not everybody does it, but they know that it can be beneficial for their future. For those that are able and engaged in investing, a good percentage will invest their savings through their financial institution, a financial advisor or some will do it on their own. Financial planning helps investors figure out questions such as "How much do I need to save?", "How much can I spend?" or "What rate of return do I need to make?".

Before you attempt to answer these questions, you should be asking yourself the question "What is the objective of my investment?" The responses to this question can vary greatly, but might fall into one of the following categories:

- Saving for the short term (such as a down payment for a home in a few years)
- Saving for the long term (such as a retirement nest egg)
- Generating income (either as a primary or secondary source)
- Preserving your capital (looking to keep up with inflation or just very risk averse)

In the absence of having an objective for your investment, it is quite possible that financial planning software could determine that your required rate of return is something like 4% per year. Any asset allocation expert will tell you that there are hundreds of ways to construct a portfolio that can be expected to make a rate of return of 4%: it could be 4% purely in the form of income, it could be 4% through a combination of dividends and capital appreciation across a variety of conservative equity markets or it could be a portfolio that has very limited risk of producing a negative return over short periods of time (i.e. strong downside protection). Until you identify the specific investment objective that you are trying to achieve, there can be a lot of uncertainty in how best to create a portfolio that will satisfy your financial needs.

What goals-based investing attempts to do is to put your investment objective as the starting point in constructing a portfolio that will accomplish what you want it to do. Once that is defined, the variable(s) that need to be optimized are known, and you can place other constraints, limits, or preferences into your quantitative models that collectively produce a portfolio that will optimal for achieving the investment objective.

As an example, consider a new retiree who is single, has a company pension of $20,000 per year and is entitled to government benefits of $15,000 per year. It is determined that the pensioner will require an additional $10,000 per year from investments to live comfortably, and has a non-registered investment account worth $250,000. If the pensioner were to go to a typical institution or financial representative that does not use goals-based investing, it is most likely that the portfolio recommended would be something along the lines of a "Moderate Growth" portfolio or 40% equity, 60% fixed income. This portfolio would be expected to deliver a return of roughly 4% with the lowest volatility possible. The portfolio would rank as a 2 out of 5 in the risk/return spectrum of the five different portfolio options that the firm offers.

This recommendation is likely the result of using modern portfolio theory (MPT) or optimization to determine the portfolio. Companies who use this approach are quick to point out that a Nobel Prize was awarded for the work done in this area back in the 1950's by Harry Markowitz. The biggest problem with MPT is that it is 2-dimensional – there is risk (defined as the volatility of investment returns), and there is return; there is nothing else. To many people, risk is not defined as some statistical measure, it is the probability of losing money, making one of the 2 variables used by MPT of questionable value!

Goals-based investing does not restrict the analysis to the same 2 variables. The variables could include theoretically anything: income yield, after-tax total returns, probability of loss in the short term or the long term, etc. Goals-based investing can also use the same principles of MPT, but also add in many other forms of quantitative analysis including simulation, scenario analysis or stress testing to name a few.

Going back to our example, the same pensioner who provides the financial scenario to a company that uses goals-based investing is likely to get a portfolio recommendation that will provide almost all of the 4% required return in the form of income, the income would likely receive more favourable tax treatment, there will be little or no need to regularly realize gains (i.e. sell securities to make up for the shortfall in income) and the probability of losing money should be lower. That would be a win-win-win-win situation!

If done properly, goals-based investing is a more customized approach to building portfolios, and it results in investors having greater choice available to them to have a portfolio that has a greater likelihood of meeting their financial objective. Not using goals-based investing reminds me of a Henry Ford quote: "A customer can have their car painted any colour as long as it's black." Don't settle for a black car, find a company that offers goals-based investing and get any colour that you like!