Goals-Based Wealth Management In Practice

CFA Wealth Management Conference 2011
Calgary, Alberta, Canada
September 20-21, 2011

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Three Main Points

1. A different environment
2. Process architecture
3. Managing the process
A Different Environment

The world has changed and clients are asking for different solutions...

• 2008 meltdown changed investors
  – not a cyclical event
  – disappointed return expectations
  – illiquidity surprises
  – no diversification when it was needed

• Das, Markowitz, Scheid & Statman [2010]
  – hitherto debate on optimality
  – academic imprimatur
Process Architecture

• Integrated wealth planning
• Goals-based asset allocation in practice
• A practical model
Integrated Wealth Planning

Wealth management brings multiple disciplines together...

• Describing investors goals
  – Estate, financial, philanthropic, investment
  – Understanding asset location

• What matters to the family

• Identify the worst nightmares
  – Changing one’s lifestyle
  – Failing descendants

• Identify the most cherished dreams
  – Personal, dynastic or philanthropic
Goals-Based Allocation in Practice

• The starting point – behavioral portfolio
• The first iteration
• A new iteration:
  – Three sequential branches
  – Multiple questions
  – Several feedback loops
Three Fundamental Goals...

HNW investors usually have three distinct generic goals that compete for their attention...

- **Personal:**
  - Meet current and unanticipated needs
  - Maintain future flexibility

- **Dynastic:**
  - How much should my children get?
  - What about generations beyond them?

- **Philanthropic:**
  - Active or passive philanthropy
  - Philanthropy as a family value
This design, initially proposed by Meir, Statman, illustrates the fact that we have different views of risk for different goals...
The First Iteration...

1. Describe the main goals of our investor
2. Structure a sub-portfolio for each goal
3. Dollar weigh and prioritize these goals
4. Optimize portfolios across the whole
A New Iteration...

Experience suggested the need for further refinement to recognize families’ special issues and their main nightmares...
A New Iteration...

The first step is to distinguish between internally and externally managed family assets.
A New Iteration...

Within the internal asset category, one can further look into the risk associated with individual pools of assets ...

- **Family Assets**
  - **Internal**
    - Cap. Pres.
      - Low risk, income producing
  - **External**
    - Growth
      - Family business ventures
A New Iteration...

The second step involves isolating the assets needed to meet the family’s lifestyle...
A New Iteration...

Within the lifestyle assets, one needs to distinguish between short- and medium-term assets as inflation affects them differently ...

- **Family Assets**
  - **Internal**
  - **External**
  - **Cap. Pres.**
  - **Growth**
  - **Lifestyle**
  - **Non L.S.**
  - **Short term: 3-5 years**
  - **Long term: 6-15 years**
A New Iteration...

The third step is to uncover the family’s needs beyond life style ...
Why Seek or Avoid Growth?

One should not simply assume that a family SHOULD seek growth because it has been the norm hitherto ... 

- Unexpected inflation
- Lifestyle changes
- Generational fragmentation
- Mission related investing
- Decision risk minimization: scorekeeping
- Other ...
A New Iteration...

Within the non-lifestyle dedicated assets, it is still important to understand differences and specify what is needed and how ...

- External
- Lifestyle
  - Short Term
  - Long Term
- Non L.S.
  - Cap Pres.
  - Growth
  - Other
    - Nominal or Real?
    - Liquid or Less?
    - What? How?
A Practical Model...

- The fundamental concept:
  - The advisor is a TRANSLATOR.
  - The family expresses goals in its own language.
  - The advisor translates them into financial and investment language.
A Few Initial Caveats

Like any model, it is important to understand capabilities and limitations ...

• Key assumptions must make sense
• Avoid determinism
• Promote discussion of trade-offs
• Provide sufficient feedback loops
• Protect against misunderstandings
• Stay humble and flexible
Key Assumptions and Inputs

The process starts with the crucial inputs, which combine generic and highly personal family data...

- Capital markets assumptions
- Financial asset totals
- Current lifestyle needs
- Anticipated lifestyle inflation
- Life expectancy of principals
- Asset holding structures
- Any other issue?
Key Case Assumptions...

- A family with financial assets of $35 million
- Current annual spending $1 million
- No internally generated income
- G1 aged around 50
- Inflation expected around 3%
Separating Internal & External Assets

- Internal capital preservation: $2 million
  - Apartment complex with rental income
- Internal growth: $1 million
  - Venture capital start-up
  - Managed by member of G2
Assessing Lifestyle Needs ...

• First 5 years: $4.7 million
  – Return assumption: 4%
• Next 10 years: $7.2 million
  – Return assumption: 6%
• Feedback loop
  – $11.9 million is less than total assets
  – Family is comfortable with findings
• Plan on replenishing as appropriate
  – To maintain the 15-year horizon
Dealing With What is Left...

- Additional lifestyle goal
  - Provide for at least another 15 years

- Opportunistic goal
  - Reserve 10% of portfolio for themes

- Growth goal
  - Provide for dynastic and philanthropic goals
  - Maintain adequate liquidity
  - Do not over-commit to private equities
## Personal Goal Summary

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount ($000)</th>
<th>Share of Total</th>
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<tbody>
<tr>
<td>ST Lifestyle</td>
<td>4,716</td>
<td>13.5%</td>
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<tr>
<td>LT Lifestyle</td>
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<tr>
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<td>Internal Investments</td>
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<td><strong>Total</strong></td>
<td><strong>35,000</strong></td>
<td><strong>44.1%</strong></td>
</tr>
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</table>
Creating the Policy Portfolio...

The process involves the interaction of two important components

• Individual sub-portfolios
  – Solely driven by client goals
  – Sized by translating client needs
  – Unique combination for each individual

• Sub-portfolios constructed through modules:
  – Modules are driven by return/risk profile
  – Modules are matched to individual goals
  – Client preferences integrated in process

• Each client portfolio is unique
## Resulting Portfolio - $ Amounts

<table>
<thead>
<tr>
<th>Tax-Aware</th>
<th>4,716</th>
<th>5,765</th>
<th>6,033</th>
<th>3,061</th>
<th>3,500</th>
<th>5,425</th>
<th>3,500</th>
<th>2,000</th>
<th>1,000</th>
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<td>35,000</td>
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# Resulting Portfolio - % Share

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<tr>
<th>Tax-Aware</th>
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<th>Non-Lifestyle</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>ST</td>
<td>LT</td>
</tr>
<tr>
<td>Fixed Income and Related</td>
<td>100.0%</td>
<td>80.0%</td>
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<tr>
<td>U.S. Municipal Bonds Inv. Grade</td>
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<td>42.5%</td>
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<tr>
<td>EAFE Fixed Income Hedged</td>
<td>10.5%</td>
<td>7.5%</td>
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<tr>
<td>U.S. Municipal Fixed Income HY</td>
<td>9.0%</td>
<td>9.0%</td>
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<tr>
<td>EM Debt</td>
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<tr>
<td>Non-Directional Hedge</td>
<td>21.0%</td>
<td>21.0%</td>
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<td>Public Equity and Related</td>
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<td>U.S. Equities</td>
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<td>Internal Growth</td>
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<tr>
<td>Total</td>
<td>100.0%</td>
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Goals-Focused Modules

- The set must cover all categories of needs
- Contiguous modules: sufficiently different
- Individual modules: as optimal as feasible
- At least four families of modules:
  - Tax-aware with non-traditional strategies
  - Tax-agnostic with non-traditional strategies
  - Tax-aware with only traditional strategies
  - Tax-agnostic with only traditional strategies
- Must leave room for flexibility
Managing the Process

- Superficially complex
  - Unique portfolio for each family or client
  - Potentially as many benchmarks as clients

- Practically simpler than it looks
  - Goal modules: common across platform
  - Thus, room for standardization

- Essentially amounts to “mass customization”
  - Complexity is where it belongs
  - Leverage across investment management
In Short, Three Main Points

• A different environment
  – 2008 changed needs and market opportunities
  – A new academic validation
  – Goals-based wealth management: new normal

• Process architecture
  – Builds on existing concepts
  – Three-step process

• Managing the process
  – Allows mass customization
  – A number of practical issues remain
Limits of the Process

• Selected client preferences
  – Asset class or strategy preferences
  – Must be prepared to deal with exceptions

• Path dependency
  – Transitioning a pre-existing portfolio
  – Dealing with concentrated positions

• Investment reporting complexity
  – Selected strategies in more than one module
  – The correct use of benchmarks
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