Commentary

April 2017

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Risk Management: Goals-Based Investing

- In keep with our history as a pioneer of goals-based investing — we believe a focus on goals means putting as much emphasis on understanding how investors use their portfolios as we put into portfolio construction.
- The risk-management objective of stability-focused portfolios is to minimize the risk of large losses, while growth-focused portfolios define risk as the possibility of insufficient long-term growth.
- In every case, investors must be conditioned to exhibit behaviors that support the investment plans developed to achieve their goals. Buying high and selling low can derail even the best-laid plans.

Up until this point in our *Risk Management* series we have addressed risk in practitioner's terms. Risk also exists in forms that are familiar to those charged with funding a budget — personal or professional — but not especially concerned with the mechanics of investment management.

These investors face many types of risks: factors that account for the volatility of financial asset returns, the degree to which a manager's process reflects its philosophy, operational decisions that affect strategy implementation, and more. But in the abstract, none of these risks are necessarily greater than the others.

So, what is the single greatest risk that investors must confront?

We believe the answer is "failure to achieve their goals." This may seem like a broad oversimplification, but it is hard to dispute.

Turning Goals into Actions

Investors have many different goals, although there are a few like funding retirement (at the individual and plan levels) and paying for college that receive the lion's share of attention. Most are tied to a time horizon.

- Point in time: accumulate a pre-determined figure by a certain date.
- Extended period: distribute a specified amount every year for several decades.
- Combination: accumulate up to a point, then distribute over time.
- Open-ended: accumulate or distribute in perpetuity.

Goals, as it happens, have their own subset of risks.

- Shortfall risk: failure to reach an accumulation goal
- Longevity risk: outliving the distribution of one's savings
- Sequence risk: encountering a poor investment environment at a disadvantageous time (typically associated with an investor's transition from accumulation to distribution)

The repeated references to accumulation and distribution are a product of the integral role they serve in setting investment goals. In a sense, every decision an investor must make to develop an investment plan will fit into one of these phases. How many years will be dedicated to accumulation? What periodic distribution rate is required?

Asset-liability matching is a helpful paradigm for developing actionable investment plans around financial goals. We can express, for example, a retirement savings target as a future liability and then determine the initial and ongoing funding costs, or assets, required to satisfy it just as pension plans do. That retirement savings target is itself derived from the anticipated series of distributions, or income liabilities, created by the retirees' need to replace the income formerly provided by a paycheck.

Investor engagement serves a key function at this stage for several reasons. First, the goals and their associated liabilities belong to the investors, which means the assets to fund them will need to come from the investors as well. This funding commitment therefore requires some level of sustained participation from the investors. And progress toward the goals will be deeply important, so investor perception and the behavior it invites require careful management.

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Accounting for Behavior

SEI has served as a pioneer of goals-based investing, building on research published almost fifteen years ago in “Goals-based Investing: Integrating Traditional and Behavioral Finance.” We believe a focus on goals means putting as much emphasis on understanding how our investors use — and think about — their portfolios as we put into their construction.

Putting aside for a moment the quantitative, statistical and historical precedents that we reference to establish a framework for our investment and risk-management decisions, an investor-centric goal-based approach means that we need to be mindful and accommodative of investors’ behavioral tendencies.

This perspective suggests we should cultivate with investors an enduring tolerance of portfolio performance, especially during downturns. After all, a strategy has the best chance of working if it remains invested for its full intended time horizon. Picture the disruption created by investors frustrated enough by a poor market environment to liquidate their holdings near a low point. Or perhaps the interruption is less severe, but the investor no longer feels inclined to continue making the contributions needed to fund a future liability.

Stick to the Plan

The practical implications that arise from the need to minimize behavior-driven impediments form a dedicated component of our risk-management work. In fact, they inform the overall design of our goals-based portfolio program.

If destructive behavior can prevent investors from achieving optimal investment outcomes, then we need to develop portfolio strategies to solve for those behaviors. Mental accounting, or the tendency of investors to apply different risk tolerances to different goals (often with different time horizons), can be accommodated by disaggregating a portfolio to mirror those differences.

This represents a theoretically suboptimal departure from traditional finance, which views financial wealth as a single portfolio. But it may be more optimal if it prevents an investor from engaging in self-destructive, emotionally driven behaviors.

One large portfolio that balances various risk-return considerations and time horizons with an allocation that changes over time may be the most concise way to address investor’s goals. But the portfolio’s aggregate risk presents a challenge; what happens in a poor environment when the portfolio’s value drops 20% for the year?

Investors would likely be more willing to ride out a downturn with a strategy that links clearly to their individual goals. This could mean that, rather than having all of their assets in one large portfolio, perhaps a conservative shorter-term portfolio would be used to fund current living expenses and a more aggressive longer-term portfolio for capital appreciation. Together, they may still fall 20%, but with a relatively innocuous single-digit slide in the shorter-term portfolio, and the understanding that the larger drop in the long-term portfolio has the benefit of time to stage a recovery.

Both examples can accomplish the investors’ goals, but the latter has a much greater chance of receiving the benefit of the doubt in a market downturn.

Divided it Stands

The purpose served by these distinct portfolios extends beyond the more satisfying mental accounting that they facilitate for investors. We have specific objectives and constraints in mind when constructing shorter-term stability-focused portfolios and longer-term growth-focused portfolios.

Stability-focused portfolios aim to meet income needs in the immediate or near future, so it is important for their assets to be relatively stable and liquid. Accordingly, the risk-management objective and asset allocation for these portfolios adhere to a strict budget in an effort to minimize the risk of large losses.

Growth-focused portfolios seek to support the attainment of longevity goals and therefore define risk as the possibility of insufficient long-term growth.

Potential assets for these portfolios are screened according to risk metrics such as peak-to-trough declines. Assets with higher return expectations but that have suffered greater declines are more tolerable in growth-focused portfolios due to their longer time horizons and recovery periods. These assets must be used much more cautiously in stability-focused portfolios, however, as they could impede more immediate funding needs.

Risk Management: Enterprise Risk Management

Our series on SEI’s approach to risk management will conclude with a paper that explores how SEI’s enterprise-level risk management capabilities help support our investment management operations.

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