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Redefining the basics of goal-based investing

The rules created for institutional investors are usually applied to individual investors, whereas they need their own sets of investing rules and matrices

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worth individuals and their advisers, said, “The single most important retirement goal that individuals have is that they don’t want to change their lifestyle, in a way that (my) neighbours will notice.”

While institutional investors can have a single major goal of maximizing returns, individuals can have multiple subjective goals with varying time horizons. Hence, the approach to investing also needs to be different and account for a lot more than just maximizing returns.

Brunel advocates adapting changing the approach to risk-return processes—when it comes to individual portfolios—rather than following traditional finance theories, which work better for institutional portfolios. Here is a look at this different approach towards determining the risk-return balance for individuals.

Risk Measure

Traditional finance measures risk as volatility. For example, when we say that equity is a risky asset, what it means is that equity prices can move up and down in a wide range and this volatile movement is the basic risk in equity investing. Ultimately, when you invest in assets, you hope to buy at a price lower than what you might sell at. If prices are volatile, regardless of the factors affecting them, your final investment value will get impacted.

Along with the risk tolerance of an investor, asset allocation also needs to consider the asset class risk like the above equity risk. Brunel proposes that instead of the traditional way of looking at risk as volatility in prices, for individuals, it is important to understand assets in context of goals. He said, “Risk for individuals is the probability of not achieving, or missing a goal. When expressed in this manner, it may lead to more effective choice of assets for different goals.” Let’s assume there is a 2-year goal for buying a house. This means an investment needs to be made towards the down payment.

Question: what is the probability of missing the goal if you invest in equity? Answer: ideally, it would be a high probability given the short time frame. So, you would not pick equity as the asset for this goal. Replace equity in the above question with debt and you may find that the answer veers towards safety and fits the goal. Similarly, this exercise can be repeated for other goals. Many financial advisers do consider the priority of goals, time horizons and risks, though their methods can differ.

Varun Girilal, co-founder and executive director, Mitraz Investment Advisors says, “We do not bucket investments at an individual goal level. We find it more efficient to do this at an asset class level after considering all the goals that need to be achieved. Short-term goals can be addressed separately; for long-term goals, when we reach closer to the time when the money is needed, funds get shifted out of riskier assets into less-volatile options.”

Return Determination

Once goals are set and risk is measured, you will be able to select the appropriate assets. But what is the return that one must strive for? In determining the investment requirement for achieving future goals, the average expected return from the asset is used as a discount rate. That becomes the return threshold to cross. While this works well for institutional investors and project investing, Brunel argues that individual investor portfolios do not benefit from an average expected return because it assumes that at least half of the time you may earn below average returns and miss achieving the goal.

“The return one seeks is the maximum return over the appropriate horizon that should be met or exceeded X% of the time, that percentage being the minimum required probability of success,” he said.

eligible investments can be arrived at. This then gives the highest return that should be met or exceeded over the horizon with the required success ratio. Same can be done for other goals with longer time horizons and differing urgency to succeed. What you arrive at is the return threshold that you must exceed, or you should earn at least that much on your assets for your goal to be fulfilled.

Risk Determination

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Lastly, an investor's risk profile can also be defined precisely by considering the various financial goals. Risk profile is important when it comes to selection of assets to fulfil goals. Again, methods differ but outcomes can be similar if the focus is on goals.

"We begin with a psychometric questionnaire to determine risk tolerance and go through a scenario of how different portfolios have performed in different conditions. This helps in ascertaining client's comfort level. Moreover, when there is more than one person involved in a financial plan, both have to be convinced about the asset allocation regardless of the risk profiles," said Vishal Dhawan, founder, Plan Ahead Wealth Advisors.

Brunel suggests that an individual's actual risk profile is bottom-up or the weighted average of the risk of each of the defined goals. Weight used is the portion of the individual's total assets needed to meet that goal.

"Assume there are two goals: the first is to have enough money to meet lifestyle expenditures for the next 5 years with a 95% probability and second is to invest the remaining assets in a portfolio to preserve capital. Assume that the first sub-portfolio requires 20% of assets and has an expected return volatility of 4%; assume as well that the second portfolio has an expected return volatility of 7%. Thus, the overall risk profile will be 20% of 4% (i.e. 0.8%) plus 1-20% (i.e. 80%) of 7% (i.e. 5.6%), which equals to 6.4%," he illustrated. For individual investors, these calculations can be hard to grasp but the concept itself is simple: your risk profile is measured as an aggregate of the amount you require for each of your goals and the urgency of achieving that goal.

What also needs to be addressed is the behaviour biases that individuals display. Dhawan says, "Even if all the goals are long term, at times we do not invest everything in high-risk assets like equity, because of behavioural impact. Panic can set in if returns are too volatile in the short term. An overlay of strategic allocation helps maintain a balance."

Individuals are usually labelled as aggressive, moderate or conservative investors. In reality, one label rarely works. While you may choose an aggressive approach with a certain goal, for a different goal you may be very conservative in your investment approach. Thinking deeper about your goals helps in the most effective investment results. These results are not always defined by the best return—often it is simply about successfully achieving the purpose for making an investment.

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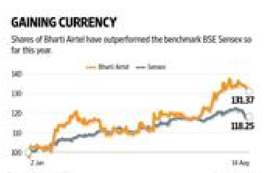

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