Goals-Based Investing for Better Risk-Return Tradeoffs

Process seeks to increase likelihood that clients will meet objectives

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What is the idea behind goals-based investing?

MASSI DE SANTIS: Investing is about making tradeoffs between asset growth opportunities and the risk of not meeting stated financial goals. Goals-based investing is an approach that seeks to make the most efficient risk-return tradeoff for the goals being pursued. The first step is setting the financial goals. Risk in this framework is defined as the uncertainty that an investment will meet a stated goal. In this sense, goals help define key risks and the appropriate investments for managing those risks. For example, the risk-free asset may be very different for an investor saving to purchase a home next year vs. an investor saving for retirement.

Once financial goals and risk management assets are defined, investors can choose to allocate some of their savings to assets that increase the uncertainty of meeting their goal but have higher expected returns (growth assets). Identifying the right risk management assets allows them to make a better risk-return tradeoff for their goal—potentially improving their expected returns for the risk taken. The chosen combination of risk management assets and growth assets will then depend on investor characteristics and risk preferences.

How can investors benefit from this approach?

DE SANTIS: The process may boost the likelihood of meeting financial objectives. Non-goals-based solutions can lead to waste because capital may be allocated to management of risks not relevant to the investor (e.g., capital preservation...
Goals-Based Investing: What Are the Typical Steps?

- Determine investment goals
- Identify key risks and the relevant risk management assets associated with each goal
- Construct a dynamic investment solution for the goals, based on investor characteristics and risk preferences

It also simplifies planning and communication, providing clarity to investors. Consider an investor with two goals: a desired level of consumption in retirement and a bequest. The goals-based investing approach can be used to estimate the amount of capital needed to fund future consumption, which is an income goal, with an estimated level of uncertainty. The remaining capital can be used to fund the bequest, which is a wealth goal. The investor has found an efficient solution to the investment problem and has more clarity about the outcomes he can expect.

How would you design an investment plan that addresses both consumption and wealth goals?

DE SANTIS: Assume our investor is a business owner (see Exhibit 1). He wants to convert some of his business capital into retirement consumption and leave the remaining capital to his children in the form of a gift. With the help of an advisor, he determines the level of inflation-adjusted consumption needed to support his expenses from ages 65 to 90 (expected lifetime plus a buffer). A low-risk investment for this goal can be a portfolio of Treasury Inflation-Protected Securities (TIPS) matched...
to the investor's withdrawal horizon. The investor can then combine the TIPS portfolio with a global equity portfolio based on his risk preferences. The advisor determines how much capital is required to fund the consumption goal, and the remaining capital is dedicated to a wealth-based allocation.

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For example, the advisor may determine, based on the investor's risk preference and horizon, that a 60/40 portfolio of global equities and a global investment-grade bond portfolio is appropriate for the goal. This process can also be iterated, allowing the investor to choose the combination of consumption-bequest targets that best addresses his needs and tolerances.

Are income and wealth goals better addressed using distinct strategies?

DE SANTIS: Once a plan is designed and the desired asset classes are identified, the advisor implements one overall portfolio. The key is that components of the portfolio address specific needs. This approach generally leads to a more efficient risk-return tradeoff relative to a generic portfolio not tailored to the goals. In addition, by allocating assets to separate goals, the approach allows investors to monitor progress toward each goal and make changes to their plan along the way. Goals-based investing adds clarity by providing the relevant information needed to monitor progress. Total portfolio value and returns may not capture this information.

Does Dimensional offer any tools to help advisors design goal-based plans?

DE SANTIS: On the planning side, we developed a tool that advisors can use to address the consumption goals of their clients—how much to save and invest for the goal. On the investment side, Dimensional believes retirement solutions should be constructed to address consumption as the goal. We offer a wide range of equity and fixed income strategies that we believe can be used to help individual investors meet their income and wealth-based goals.

Investing involves risk and possible loss of principal. There is no guarantee strategies will be successful.

Investments in stocks and bonds are subject to risk of economic, political, and issuer-specific events that cause the value of these securities to fluctuate. International investments are subject to additional risks such as currency fluctuation, political instability, and adverse economic conditions. Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, call risk, and other factors. Inflation-protected securities may react differently from other debt securities to changes in interest rates.

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