The Journal *of*
Wealth Management

VOLUME 22, NUMBER 2 FALL 2019

Cover design: Loewy Design

ON THE COVER

Aquamanile in the Shape of a Bird
Earthenware
7th Century AD–9th Century AD
11.5 inches (29.2.5cm) high × 12.5 inches (31.8cm) wide
Photo credit: Barakat Gallery

Recognizably compared to the depiction of the buraq of Islamic tradition or often mistakenly described as Muhammad's horse, the buraq was once described as being part eagle and horse, thus resembling a Pegasus-type creature. The carved vessel, in buff earthenware, stands unglazed and coated with a white slip adorned with dark brown decoration. It features a rising, long neck with the face of an animal surmounted by convoluted antlers. To either side of the neck, two hooks are shown with free-moving rings, another ring on the lower front mid-section, one attached to each leg, and another behind the bed transverse handle attached to the back of the bird. The wings to the back side were added to the vessel in appliqué The geometric decoration includes octagonal medallions with lines radiating from the center as to resemble a rosette. This detail would be consistent with Central Asian attribution. This piece and other antiquities are available through Barakat Gallery UK and abroad. Visit www.barakatgallery.com to view more fine works.

Though it is by no means a new issue, I want to use this letter to focus anew on goals-based wealth management in general and goals-based strategic asset allocation. On the one hand, an ever-larger number of advisers use the approach to help their clients find a better way to achieve their individual goals. This is the good news. On the other hand, an honest look at the processes used unfortunately suggests that the term "goals-based" is more a marketing label than a financial reality. That is the bad news.

The more I focus on the challenges posed by goals-based asset allocation, the less worried I find myself on the issue of the so-called added complexity. While it is true that the very fact of adopting a bottom-up approach to creating unique portfolios for individuals does make for some additional complexity, it is also quite true that the complexity that is introduced is well worth it. Using the appropriate software tools, that complexity can easily be managed, with the substantial upside that, without a goals-based approach, the odds of achieving the real goals of each client are quite unfavorable.

Let me dispel a few of the most frequently heard objections:

(1) **A goals-based asset allocation is often quite similar to a traditional 60/40 (or some comparable fraction) equity/bond exposure.** So what? The fact that many individuals describe goals that are met by a portfolio structure that is coincidentally not different from the one that one would derive is no excuse for not doing the right work. What if my next client is not served by a 60/40 strategy? Should I accept to view him as a casualty of an advisory process that claims to be focused on the client but is not? More importantly, there are two important benefits associated with the goals-based approach that are *ipso facto* foregone. First is the opportunity to help the individual "wed" his or her money and thus understand better what that money does for him or her and what the limitations are in certain market conditions. Second is the fact that individuals tend to vary their goals as time passes, and they become more familiar with what is achievable and what is not, with what investment risk is and is not, and how crucial certain goals are or are not.

(2) **Goals-based asset allocation diminishes the role of portfolio managers.** I must admit that this is one of the statements with which I have the greatest problem. Indeed, I would have thought that a process that distinguishes advisory and investment services actually frees up portfolio managers to concentrate on investment issues, delegating to wealth managers the role of helping define the best overall strategy. "Yes, but what do wealth

managers know about the risk/return profile of assets or portfolios?" is the most frequent objection. My answer is simple: portfolio managers or investment specialists are the ones who construct the model portfolios that are used to match individual goals and an asset allocation that has the best chance of meeting the goal, with the required urgency and over the time horizon…

In fact, one can view the goals-based process as the analog of the more traditional approach where a manager offers a small number of model portfolios and then aims to match each client with one of these portfolios based on some perception of the client's risk profile. The main difference here is that instead of matching each client to one portfolio, one matches each of the client's goals with one of the model portfolios. The key insight is thus that the risk profile of each client is not determined from the top down, but rather built up from the bottom, by weighing the risk associated with each goal given the portion of the client's assets that must be allotted to each goal.

(3) **Even if one could agree to the "bucketing process" used to create the asset allocation, having multiple sub-portfolios within each client's asset base is too complex.** Where does this one come from? The fact is that many advisers manage their clients' assets through the management of that small number of model portfolios, whether these are structured formally as commingling vehicles (common trusts, mutual funds, or limited partnerships) or simply as guidance that is then applied to each client's portfolio. Whether one invests the whole of a client's assets in these commingling vehicles, or sets of guidance allocations, or a part of each client's assets, it is hard to see where the additional complexity is, other than in a potentially larger number of transactions each time a portfolio is rebalanced. The process can—and often is—computerized and one is left to wonder why asset managers prefer to protect their margins at all costs rather than serve their clients to the best of their abilities.

(4) **Goals-based allocation may be the right solution when people are in an asset decumulation phase, but it does not work while one accumulates assets.** Here again, I beg to differ. Clearly, the process was initially developed to match assets with goals. Thus, matching future goals and future asset levels requires a bit of an intellectual rejuggling. However, it is far from rocket science. In fact, it may actually be the best way to help competitive individuals see what asset level they ought to have each of the next x number of years to achieve their goals. By comparing the level of assets they actually have and the amount they should have, one can see first some animal spirit motivation and second the need for individuals to increase their savings over time if and when they perceive either a rising sense of urgency in the goal or the likelihood of its term getting closer.

(5) **Individuals often cannot describe their goals far into the future with the required level of precision**. While this is a reasonable observation, does it mean that one should do nothing if one cannot define goals precisely? I saw an interesting twist on this idea a year ago in a European country where the two goals that were given to me for a case study were (a) having sufficient income to continue with my current life style for the next ten years and (b) having in 10 years the same purchasing power with what will be left as I have today. The insight of the second goal simply is that the client does not know how "things" will turn out in the next ten years and want to keep all options open until then. Helping the adviser coach the client on the risk that the client had to accept given current asset levels and the probability there was of achieving that goal was an eye opener to her, the adviser.

In short, the reality is that individuals—and, I should add from the 15 years of my professional life spent working with larger pension funds or similar institutions—come with a variety of biases. Many institutions have some trouble sticking to a true asset/liability framework—at times experiencing the agency risk aptly described by David Swensen, where managers substitute their own risk profile to that of their clients. Like them, individuals often come to the "party" with a number of biases, which are all the more understandable as most of them did not create their financial assets through working in the financial industry. Charlotte Beyer was able to observe that changing horses in the middle of a race was the most frequent cause of investment dissatisfaction among the people she advised. Thus, finding and sticking to an approach that maximizes that staying power is not only the most suitable way of performing a form of asset/liability matching in the individual investor world, but is also the one that minimizes the risk of investment catastrophes.

▪ ▪ ▪

The Fall 2019 issue of *The Journal of Wealth Management* has been more difficult than our last issue when it comes to grouping articles. Indeed, we may actually have more variety than we have seen in quite some time.

The first two articles relate to the role of behavioral finance in the way in which individuals make investment decisions. The first, by Michael Pompian, provides a quantitative analysis of behavioral mistakes using a fictional case study of a private family that is making two key behavioral mistakes: loss aversion and mental accounting, concluding that the value of behavioral advice is significant. The second, by Renu Isidore and P. Christie, explores the relationships between the behavioral biases exhibited by the secondary equity investors in India and the type of decision-making tool employed to make the stock selection decision.

The next four articles deal with various investment issues, with three of them focused on evidence from emerging markets, such as India and Brazil. The first, by Paskalis Glabadanidis, focuses on so-called smart beta, proposing an alternative equity weighting mechanism based on the statistical significance of the factor loading on the benchmark and presenting evidence that this strategy achieves higher correlations with the benchmark than popular alternatives, has lower tracking error, unity exposure to the benchmark and very good Sharpe ratio and ex-post realized active return. The next piece, by Alexandre Daltro and Ricardo Leal, looks at the fact that passive equally weighted strategic asset allocation portfolios outperformed actively managed balanced funds in the same period in Brazil. The third, by Peeyush Bangur, focuses on the performance of four different options spread strategies on the Indian stock market index, Nifty. Concluding that the better return of bull spread strategies indicates that Nifty has less bearish than bullish behavior while the better performance of bull call spread over bull put spread indicates that Indian stock market gives excessive return to the investor. Our final piece in this section is also focused on India and constitutes a lengthy but interesting evaluation of the effect of macroeconomics on mutual funds, by Sonali Agarwal.

Our final three articles are, as is often the case, quite heterogeneous. The first, by Jeffrey Madden, asks a perfectly fair question: are GAAP Accounting in general and Price/Earnings in particular, the best ways to analyze companies in the new economy where a life-cycle framework might be better suited for investors to navigate the New Economy. Our penultimate piece, by Ross Riskin, looks at 529 College Savings Plans under the Tax Cuts and Jobs Act of 2017 (TCJA), given the increase flexibility investors have when using them for more than just qualified higher education expenses. Our final paper by Anwar Othman, Syed Alhabshi, Razali Haron, and Azman Noor, investigates whether the new crypto-currencies have been able to perform the functions of financial intermediaries and suggests that banks should be encouraged to either invest directly in crypto-currency or to consider them as an alternative investment asset for their portfolio investment diversification strategies.

Jean L.P. Brunel
Editor