GenSpring FAMILY OFFICES

Goals-Based Wealth Management

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Goals-based wealth management has attracted a lot of attention over the last few years, as the financial market meltdown of 2008 changed the way many families look at how their wealth is managed. While significant losses in market value have occurred at other times in history and did not necessarily modify investors' attitudes, 2008 was different in two ways. First, it challenged a number of expectations as to what could or could not happen. The simultaneous substantial price declines and liquidity losses that affected several alternative strategies forced investors to rethink significantly the way in which their portfolios were allocated. Second, because the domestic crisis occurred in the midst of a global economic and financial restructuring, many viewed it as an example of a new normal rather than an isolated incident.

In this white paper, we discuss the practical dimensions of applying a framework to use goals-based strategic asset allocation together with a parallel and comparable approach to estate and financial planning to create a new, integrated goals-based wealth management process. This framework is based on research conducted by behavioral finance experts.

For years, behavioral finance researchers have identified investors as requiring a behavioral portfolio, a notion pioneered by Meir Statman and Hersh Schefrin – which includes multiple goals, each with its own risk profile. More recently, researchers have built on this concept and developed the idea of a "portfolio of sub-portfolios," each of which is designed to meet a specific client goal. Others have argued against this approach, believing that it would forgo important diversification benefits by failing to aggregate all the sub-portfolios into one. In a 2007 paper, this author offered both a modified approach to reduce this sub-optimality and an argument that the resulting sub-optimality is more theoretical than material. In 2010, researchers Das, Markowitz, Scheid and Statman demonstrated that a "mental accounting" goals-based approach results in a re-definition of risk: rather than being defined as the volatility of returns, risk is defined as the probability of failing to achieve a given goal. Importantly, they also found that this mental accounting approach was mathematically equivalent to the classic mean variance optimization (which aims to find an "optimal" portfolio), thus addressing critics who thought that goals-based portfolios might be sub-optimal. The financial services industry has begun to take notice of this academic support, and the application of the principles of goals-based investing is indeed gaining traction.

We begin our discussion of a goals-based wealth management approach with some of the key issues that families typically face when dealing with wealth planning, then discuss a framework that allows advisors to consider financial, estate, and investment planning needs, and show the practical considerations associated with the process.

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Integrated Wealth Planning

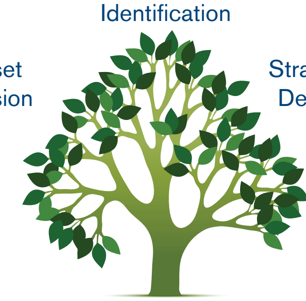
Strategic asset allocation, the process by which families work with their investment advisors to set long-term strategic targets for various asset classes, cannot occur in a vacuum. Among other factors, families must look at financial planning, estate planning, philanthropic planning, investment planning, and tax planning when creating an overarching wealth management strategy. Other than investment planning, however, each factor requires a distinct focus on the specific goals of each client and a willingness to consider several, discrete goals. Keep in mind that this may include tradeoffs if certain goals prove to be incompatible.

Consider, for example, a conversation an advisor has with a prospective client regarding lifestyle changes. The concept of "lifestyle" has many dimensions. For some, it means paying the bills associated with all family expenses, ranging from shelter and food to more esoteric categories such as private air travel or unusual vacations. For others, it expands to include philanthropic and cultural development. Regardless, a discussion about lifestyle would take a very different approach than the straightforward numbers conversation about investment risk versus reward.

Most respectable financial advisors will help the family perform some capital adequacy analysis to help the members of the family understand whether they have enough assets to maintain their current lifestyle, to extend it to incorporate their dreams, to protect them against risks and nightmares and to deal with any form of additional contingency. Yet, such an exercise is often disconnected from the work of the investment advisor who may not incorporate all these important data points into his or her strategic asset allocation analysis. A discussion centered on the family's goals is by definition fully integrated into the overall advisory process. It should start with financial planning and then naturally extend into investment, estate, tax, and philanthropic considerations. Other important considerations are the need to harmonize tax and estate planning and strategic asset location.

Goals-Based Asset Allocation in Practice

The goals-based strategic asset allocation process can best be explained as a decision tree with three critical branches.



Branch One: Asset Division

The first step in goals-based asset allocation requires the family to divide assets into two categories: internally managed (where any value added is generated by the activities of the family) versus externally managed (where any value added can be traced to external managers as well as allocation among these managers and the strategies which they implement). While this may seem to be a simple step, it is important for several reasons. It provides a framework for families to view their own entrepreneurial activities, divide these activities between those that involve a high degree of risk and those that do not, and account for different liquidity levels. It allows the family to consider assets which, though valuable, are not expected to be traded, such as homes, collections, and the like. It also allows the family to specify those areas where it feels able and willing to create value, and those where it recognizes that it needs external help. Finally, it makes it possible to postulate the almost obvious: wealth is typically created through internal, often entrepreneurial ventures, while it is only dynamically preserved in the public markets. This last element is important in that it can serve as the pillar on which rational expectations are anchored.

Branch 2: Asset Identification

The second key branch in goals-based asset allocation relates to the need to separate the assets necessary to support the family's lifestyle from those that are surplus to this requirement: separating assets into lifestyle and non-lifestyle buckets. Families spending a very small portion of their capital to maintain their lifestyles are often tempted to create a form of an endowment portfolio whose income can be used to fund annual expenditures. The major problem with the endowment approach is that assets must be "located" in a structure that belongs to the people who are spending the money. This can create estate transfer or gifting issues in that it may effectively "freeze" some share of the overall assets in the hands of a generation that might not wish to keep them, unless the goal is for whatever remains of the portfolio be passed on to charity. Often, families spend too much to be able to rely solely on the income from their portfolio, therefore some families opt for a "declining balance portfolio" which is designed to fund some specific spending period.

How far ahead should one plan? While it is always possible that the future will be so different from the past that historically-based assumptions may fail to materialize, some general statistics do apply. As a rule of thumb, assuming a balanced portfolio with a higher weighting in equities, an expected return of 8% and a volatility of 12%, the probability of negative returns becomes negligible when the time horizon reaches 15 years, although it is already quite low after 10 years. With the notable exception of Japan, no developed equity market has ever posted negative 20-year returns. Historically speaking, fifteen years is the average length of time when the probability of not losing money in equities crosses the 95% threshold.

The importance of taking a long enough time horizon is simple: assuming that one has a life expectancy that is longer than the time horizon chosen, one will need to replenish the lifestyle bucket over time. This is obviously more difficult when markets are not performing as expected. Thus, the longer the time horizon, the more time for markets to perform in line with expectations. Yet, given the path dependency of the behavior of this lifestyle portfolio, one needs to assess the circumstances in which this strategy would or would not work.

Branch 3: Strategic Goals Determination

The third and final branch of goals-based asset allocation relates to the strategic determination of the family's goals beyond lifestyle maintenance. While the range of such goals is practically limitless, goals can generally be classified into one of three categories: personal, dynastic, or philanthropic. Importantly, these goals can involve an equally varied range of implied risk profiles. While some families do not need much prodding to create a list of goals, others need a bit more guidance. It is not uncommon for a family to initially assume that discretionary wealth should automatically be allocated to a growth objective. This may not necessarily be the best approach for two reasons: (1) growth has its limits, and (2) what constitutes discretionary wealth varies based on individual needs and desires. The following five questions can help families understand the need for growth and its limits.

1. **Do I worry about unexpected inflation?** The current pricing of any investment must incorporate some allowance for currently expected inflation. What about an inflation shock which might come from some structural change? Families with roots in Latin America or even parts of Europe know that inflation can flare up with little warning, but U.S. investors may have more difficulty with this concept, if only because their own economic history does not include such an event.

2. **Do I need to provide for protection against generational fragmentation?** It is a simple mathematical truism that the number of family members grows more-or-less rapidly as generations pass. While certain families will accept that the purchasing power of the capital available to each node on their family tree will decline as generations pass, others can set it as a goal that each family unit will have at least as much purchasing power as their parents.

3. **Do I anticipate a change in my lifestyle?** Though this may involve an actual change in household expenditures, lifestyle change does simply mean an opportunity to "buy more toys." Some families discover a desire to create collections; others choose to self-insure against health care or education expenses; still others may choose to increase their philanthropic activities prior to the creation of a formal charitable structure such as a foundation. The list is extensive and is only limited by the imagination of the family members.

4. **How clear is my current view of my future needs?** Early after a liquidity event, a family may be somewhat overwhelmed by their newly quantifiable wealth. They may not feel comfortable setting their goals in what might look like quite a formal manner. Certain families might anticipate that their needs – lifestyle related or otherwise – might rise over time; they would likely discover this when asking the immediately preceding question. Others might feel that a goal might be for their total wealth not to fall below a certain threshold; this would likely be the case when the family has had very limited experience with capital markets and is thus fearful that they might lose these hard-earned monies.

5. **Do I need to keep score?** In its most trivial incarnation, this boils down to a desire to "keep up with the Joneses," but there is a more important and subtle behavioral element in this question. To put it more formally, how comfortable am I with my ability to stay the course in the face of changing market circumstances? Here, the idea is that a family might feel that exceptionally high or low market returns at one point in time might lead them, through greed or fear, to alter their views of what they need. For those who are afraid of missing out, an appropriately sized "market portfolio" might provide a simple answer in that it would allow some of their assets to track "markets" however they are defined.

A Practical Framework

The starting point for the goals-based framework is to help a family translate goals and objectives expressed in non-financial language into financial realities. The framework comprises two dimensions. First, the list of family goals is open-ended; second, the "investment universe" is divided into "modules", which are designed to work with the family's internal and external assets. While there is plenty of room for customization, the framework is sufficiently flexible to allow for all but the most unusual circumstances and is properly structured to provide a measure of operational efficiency.

The framework is an extension of the typical wealth planning dialogue. While the questions leading to the discovery of the key inputs into the model might appear to be deterministic, they are intended to help the family understand the various trade-offs they may need to make.

An example below illustrates the process. Using a hypothetical family with financial assets totaling $35 million, the framework follows the three critical branches of goals-based asset allocation discussed in the previous section.

1. **Asset Division.** Internal assets amounting to $3 million are separated out. Two million dollars is allocated into an internal capital preservation module, as they represent the equity value of a modestly leveraged apartment complex which the family rents out. One million dollars is allocated to an internal growth module, and this represents the family's share of a private venture capital management start-up which is managed by a member of the second generation. The "external" assets are then divided between lifestyle and non-lifestyle buckets.

2. **Asset Identification.** The family's lifestyle bucket is separated into two distinct categories, short-term and long-term, and evaluated using a simple discounted cash flow method. The family's short-term needs for the next 5 years are estimated to amount to $4.7 million, and are invested in a short-term lifestyle module, consisting primarily of fixed income investments. For years 6 through 15, their needs are estimated to amount to $7.2 million and are invested in a long-term lifestyle module. The investment return expectations for the long-term lifestyle module are higher than in the short-term module, and this is due to a a modestly more aggressive investment strategy that extends beyond fixed income assets to include income-producing real assets, together with non-directional alternative strategies, constrained to be highly liquid.

3. **Strategic Goals Determination.** The non-lifestyle bucket, which constitutes the balance of the family's wealth ($20.1 million), is available to meet its other strategic goals. These fall under three general categories:

    a. The family is young and they feel they need to plan for their lifestyle beyond the next 15 years. Therefore, they choose to allocate another $7.7 million to a capital preservation module, which consists of investments managed with a capital preservation focus to help replenish their lifestyle bucket account as required.

    b. The family believes that the investment environment is not as predictable as in the past, and in order to meet a desire to participate in opportunities arising from macroeconomic trends, elects to allocate $3.5 million to an "opportunistic" module that allows it to be invested in a thematic manner.

    c. The balance of the assets are reserved for growth, as it is intended to meet the needs of future generations and the eventual creation of a philanthropic structure. The family divides this allocation between a growth module and private equity investments. In effect, this reflects both a preference for liquidity and the notion that their private equity venture capital firm is expected to grow and create increasing exposure to that asset class.

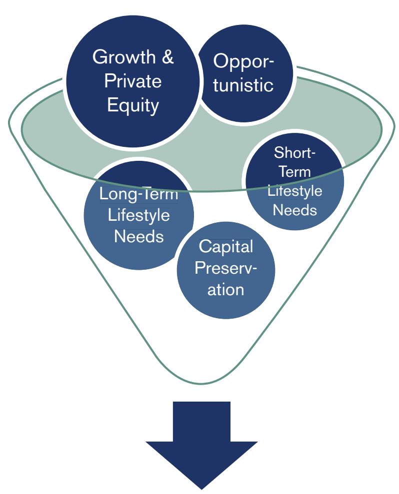
Therefore, using this framework, 56% of the family's wealth will be dedicated to ensuring their lifestyle needs, 25% to capital growth, 10% to capturing special opportunities, and the 9% balance to the ventures the family controls directly.

Once family goals have been identified, classified, and analyzed as shown in the foregoing section, the next step is to create the policy portfolio. To the extent that each family portfolio will have totally customized allocations to each investment module, the resulting overall portfolio will clearly be different from one family to the next based on individual goals. However, within each module, the guiding force is not the family's goals, but the realities of capital markets. As a sizable multi-family office, GenSpring can help achieve some economies of scale beyond personal family goals.

Depending on the needs of the families, the investment modules should have different incarnations. These options should reflect both tax status and the family's investment preferences.

Goals-Based Investing Framework

Investment Modules



Diversified Portfolio

Conclusion

While no one framework can ever hope to meet every challenge associated with the real world, the foregoing process is designed to meet the needs of a large cross-section of wealthy families, both domestically and internationally, in a way that integrates the investment activity into the broader wealth management process.

The goals-based allocation can be viewed as a "bottom-up" exercise designed to elicit the family's risk profile given the different and possibly competing goals it is trying to achieve. Families will most likely view the process as successful once they have discovered and identified their goals, quantified the capital required to meet each goal, and created complimentary sub-portfolios that meet each goal in a comfortable manner.

In the post-2008 financial environment, families need to be able to clearly map their assets to their goals with more clarity and definition. The clarity fostered by a more direct link between portfolio composition and the nature of the goal each portfolio seeks to achieve provides at least one more level of protection against emotionally-driven missteps.

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