Heritage Wealth Advisors

Thought Paper: Goals Based Wealth Management
A holistic framework to align your assets, your life and your legacy

December 5, 2014

"Wealth is not a particular sum of money. It's the freedom to do what you're passionate about and what you think is important."
- Jonathan Clements, columnist for *The Wall Street Journal*

"When you think about what to do with your money, don't think about what's on the news. Don't think about what's important to the talking heads. Most of what's out there is just noise. Think about what's important to you, and what your goals are."
– Larry Fink, Chairman & CEO, BlackRock

In the broadest terms, wealth encompasses multiple forms of investable assets including real property, insurance, cash, bonds, equities, and other ownership interests. Goals based wealth management is a comprehensive approach to providing guidance to investors that allows them to use those assets to pursue personally meaningful goals. It involves developing a financial plan, identifying and prioritizing goals, analyzing and managing risk, allocating assets, managing asset location for tax purposes, rebalancing portfolios to maintain targeted allocations, and drawing income in the most tax-efficient manner. As we deepen existing relationships, and develop new ones, Heritage Wealth Advisors continues to believe that families maximize their odds of success by using a holistic, goals based approach to wealth management. By incorporating financial planning, tax planning, estate planning and philanthropic planning, together with investment management as part of their overall wealth management strategy, investors can successfully align their assets with their life, and ultimately with their legacy. In this thought paper, we summarize how contributions to classic financial theory combine with more recent identification of behavioral biases; how defining risk, and discovering and prioritizing goals, ultimately all come together to help allocate, manage and monitor a portfolio of assets that is designed to achieve an investor's goals across market cycles.

A Brief History of Classic Financial Market Theory

Insights from the past are essential to understanding the current nature of financial market theory. We begin by highlighting the work from a select few who have meaningfully driven the evolution of financial market theory since the 1930s.

Benjamin Graham and David Dodd provided the first systematic approach to analyzing and investing in stocks in their book *Securities Analysis,* published in 1934. The authors argued that superior stock portfolios could be built by using careful fundamental analysis along with a simple set of decision rules, including purchasing stocks at prices below their current net asset value.

Harry Markowitz outlined the goal of building efficient portfolios that maximize return for a given level of risk, defined as volatility of returns, in his 1952 paper "Security Selection". The Markowitz framework, which called for combining efficient portfolios to create an efficient frontier and then for the selection of a portfolio based on an investors' risk tolerance, or utility function, led to the development of modern portfolio theory (MPT).

Jack Treynor, William Sharpe, John Lintner and Jan Mossin independently introduced the capital asset pricing model (CAPM) in the 1960s, the first general equilibrium theory in finance (Fabozzi, 2014). Central to the CAPM is the concept that investors choose the optimal compromise between expected return and the expected variance (risk) of their portfolio. In diversified portfolios, risk can be defined through the interaction of a single investment with the rest of the portfolio. Diversification can smooth unsystematic risk in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. The benefits of diversification hold if the securities in the portfolio are not perfectly correlated. Another cornerstone of classic financial theory, the efficient market hypothesis developed by Eugene Fama, states that security prices reflect all available information and that it's impossible to beat the market consistently.

In a recent article, Laurence Siegel of CFA Institute, argued (and Heritage Wealth Advisors agrees) that even though some of their findings are not always realistic these tenets of classic finance theory created in the 1950s and 1960s provide the base case, or null hypothesis, against which empirical facts, new theories, and conjectures can be tested (Siegel, 2014).

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The work previously described created a powerful body of knowledge. Heritage Wealth Advisors regularly measures manager characteristics based on the methodology made possible by William Sharpe's work, and analyzes portfolios based on Markowitz's MPT framework, with an eye toward risk and return and the correlation of asset class returns.

Behavioral Finance

Building on traditional methods, behavioral finance, which borrows from the fields of individual and social psychology, seeks to improve on the classic understanding of markets and investor behavior. It gained support in 2002 when Professor Daniel Kahneman of Princeton University was awarded the Nobel Prize in Economics (Nevins, 2004). He and other behavioral theorists have shown that many of the assumptions underlying MPT and CAPM (for example, that investors have perfect information and use it to make rational investment decisions) are inconsistent with actual investor behavior. Moreover, determining utility functions can be complicated and even sophisticated investors face challenges when trying to determine how to invest their money. For example, when asked how he would allocate his retirement account, Nobel laureate Harry Markowitz, one of the founders of MPT, confessed, "I should have computed the historic covariances of the asset classes and drawn an efficient frontier. Instead…I split my contributions fifty-fifty between bonds and equities." (Thaler, 2008)

Keeping Emotions in Check

Staying invested through volatile market cycles isn't easy. The Asian financial crisis (1997), the Russian default (1998), the collapse of Long Term Capital Management (1998), the bursting of the dot com bubble (2000), terrorist attacks in America (2001), and the global financial crisis and near collapse of U.S. financial markets (2008) represent significant examples of market volatility that tested investors resolve.

Market volatility can inevitably lead to a frantic phone call to "sell my stock" or "liquidate my investments." While these types of reactions are understandable, rash decisions can be counterproductive to generating successful long term investment results.

For example, if an investor held stocks representing the S&P 500 Index over the twelve months ending September 30, 2014, the return would have been 19.7%. However, missing just the five best days over the twelve month period of time drops the return **by over 8%.**

Impact of Being Out of the Stock Market
S&P 500 Index Sept. 30, 2013 – Sept. 30, 2014

Best Days	Return	Date	Performance Less Best Days
1st	2.20%	10/10/2013	17.6%
2nd	1.67%	12/18/2013	15.8%
3rd	1.53%	3/4/2014	14.1%
4th	1.39%	10/16/2013	12.7%
5th	1.34%	11/8/2013	11.3%
Performance if you did not miss any days			**19.7%**

Sources: Bloomberg, Heritage Wealth Advisors.
Performance from Sept. 30, 2013 – Sept. 30, 2014.

Behavioral finance research also shows that investors tend to purchase equities after markets have done well, in effect chasing returns. Alternatively, individuals typically sell securities once markets have already declined, when expected returns may have improved. Investing can be emotional, but emotions can drive bad investment decisions.

Additional behavioral hurdles that can lead to "buying high" and "selling low" include:

- Hindsight Bias: even though markets move in cycles, investors tend to project the past into the future and buy winners
- Loss Aversion: investors prefer to avoid a loss more than they value experiencing gains. This can lead to emotional selling when markets decline, or being overly conservative with regard to asset allocation
- Overconfidence: investors frequently overestimate their ability to predict market events
- Regret Avoidance: investors do not want to watch from the sidelines when markets rally and others are capturing profits
- Status Quo: investors may stick with what they have unless there are strong reasons for change

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A goals based wealth management framework provides a clear strategy to help avoid behavioral pitfalls, insert a true purpose aligned with specific assets, and even redefine the relevant benchmarks.

Defining and Allocating Risk

We believe that in order to achieve investing success it is imperative to properly define risk. In his recent newsletter, legendary investor Howard Marks wrote that while volatility is the academic's choice for defining and measuring risk because it is quantifiable and usable in the calculations and models of modern finance theory, it falls short as the definition of investment risk (Marks, 2014).

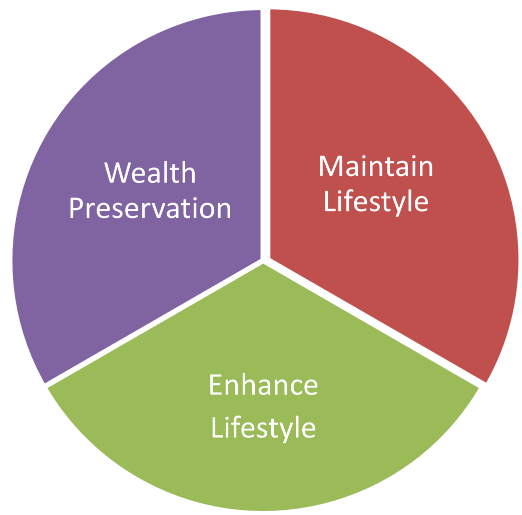
Behavioral theorists and other thought leading investment practitioners have reached similar conclusions. Investors often struggle to find significant meaning from volatility measures like standard deviation that do not describe risk in terms of clear outcomes. In a goals based wealth management framework, it is important to redefine risk in terms of goals, from the volatility of returns to the probability of failing to achieve a given goal.

The concepts of risk allocation, and corresponding portfolio assets and benchmarks, need to be assigned to three categories to best fit a goals based framework according to Ashvin Chabra, a recognized leader in the fields of investment management, risk and asset allocation (Chabra, 2005). Personal risk, or wealth preservation, is the first and safest bucket. Its function is to protect an individual's current standard of living. This area includes investable assets such as cash, insurance, and other protection oriented investments like Treasury inflation indexed securities. The expected performance of this category is below the market return in exchange for below market levels of risk.

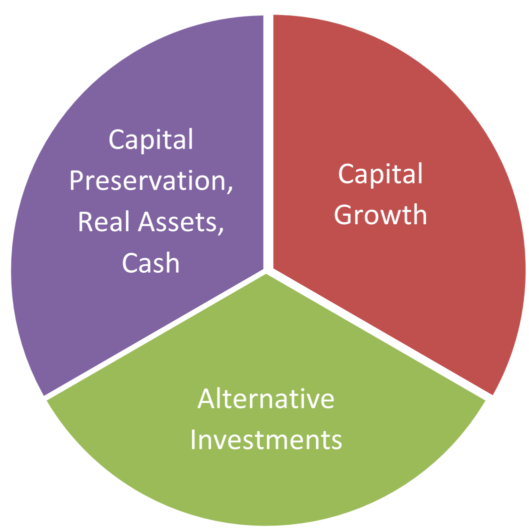
The second risk bucket encompasses market assets to offset market risk, in an attempt to maintain an investor's lifestyle. Examples of investable assets in this category include capital growth assets such as diversified global equity and fixed income investments. The category can be measured against market returns, and importantly market measures of risk.

The final risk allocation addresses aspirational risk and is designed to enhance an investor's lifestyle. From a performance expectations standpoint, it has the potential to generate above market returns with corresponding risk levels that are above the market levels of risk. Alternative investments such as private equity, investment real estate, small businesses and concentrated stock positions fall into this bucket.

Goals Based Risk Buckets



Corresponding Asset Classes



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Each type of investment — cash, bonds, stocks, and alternative investments — plays a different role in a portfolio. Cash provides liquidity. Short and intermediate bonds can offer safety and modest income, while other types of bonds offer yield enhancement benefits. Stocks seek to provide growth. Alternatives can offer low correlations and the potential for above market returns. By blending these different investments in a portfolio of both passive and active strategies, investors have the potential to add value over market cycles, provide protection in challenging markets, and reduce, but not eliminate, the risk of any one individual investment.

In a goals based framework, a risk allocation should precede an asset allocation. The market only understands risk at the aggregate level, not the individual level. Chabra points to a relevant example: A stream may have an average depth of five feet, but a traveler wading through it will not make it to the other side if its midpoint is 10-feet deep (Chabra, 2005). The consequences to an individual investor of large deviations or several consecutive years of negative returns can be significant as investors need to maintain their lifestyle and meet financial obligations regardless of market conditions. What matters isn't the individual investments you own; it's how much you have in each asset class and how you diversify. A goals based wealth management approach, built on a clear understanding of risk exposure, can help investors navigate challenging market environments by maintaining focus and discipline.

Discovering and Prioritizing Goals

Some investment practices assume that with a minimum level of questioning, investors can determine exactly what they want in terms of their goals and their comfort level with risk. Goals based wealth management allows for deeper thought, prioritization and a process reoriented around how conservative or opportunistic to be with respect to satisfying multiple life goals. The process of determining how much risk is appropriate should be driven by conversations about an investor's real life goals, not a brief questionnaire.

Goal discovery and prioritization may include such things as retiring earlier than expected, taking up more golf, traveling to Europe, or spoiling the grandchildren, to name just a few examples. A finer point can be made in the goal discovery and prioritization process as a result of deep conversations with Heritage Wealth Advisors, which include questions and conversations around topics such as:

- What are your current and future lifestyle needs?
- Do you have any large purchases planned?
- What are your objectives with regard to your family?
- What passions or dreams would you like to pursue?
- Do you want to support any charitable or community organizations?
- Are there other financial issues that you face?

Rather than regarding wealth as one lump sum, it can be useful to mentally divide amounts needed to meet specific goals. A goals based framework can help to develop a clear understanding of all the assets at your disposal, including real estate, managed investments, non-managed investments, and non-financial resources.

Investment policy guidelines can be established aimed at achieving each goal. These guidelines can help to provide clarity, priorities and resources. Change is of course inevitable so a regular review of resources, goals and priorities can allow for any necessary adjustments. Rebalancing assets periodically in accordance with market movements and risk tolerances is necessary to maintain progress to goals and manage risk. It can help investors sell high, and buy low.

Measuring Progress

As goals based wealth management gains increased acceptance, research is ongoing in an attempt to develop accurate scoring metrics for its effectiveness. The basic shift involves moving away from trying to "beat the market", as measured on a relative basis against a generally accepted benchmark, and toward a strategy that enables investors to achieve their real world goals regardless of the financial market environment (Chabra, 2012).

Traditional performance metrics remain useful and relevant for determining investment manager's absolute and relative risk and return characteristics from both an ongoing monitoring and selection standpoint. However, complementary measures may be required in other scenarios.

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For example, most investors who are approaching or in retirement desire a target spending rate that keeps the principal value of their portfolio intact. A level of spending that is too high could jeopardize a portfolio's long term value, as well as any future intergenerational transfers. Establishing a spending rule that considers the total portfolio value, and its asset allocation, along with the long run expected returns for the portfolio and inflation can help to mitigate these risks. For example, institutions like endowments and foundations have historically adopted similar metrics, such as inflation plus three percent to keep annual spending in check, and perpetually grow the long term principal value of the portfolio. These goals based performance metrics and reporting concepts are being adopted more frequently to help empower individual investors to make proactive decisions toward achieving their goals.

A More Sustainable Solution

As opposed to only seeing how investments are performing against a benchmark like the S&P 500 Index, goals based wealth management can build on traditional financial principals to improve investors' ability to monitor progress toward each of their goals. By quantifying financial goals on an ongoing basis, investors are better able to evaluate how their current assets and investment strategies are meeting their needs and aspirations. As a result, investors can remain committed to reaching their established goals, see how any potential changes might affect the likelihood of achieving one or more of their goals, and potentially reduce impulsive decision making. Lastly, goals based wealth management can help create a sense of purpose, build confidence, and maintain perspective around a customized strategy aligned with personal goals. This context can provide greater peace of mind when financial markets inevitably experience volatility.

We look forward to continuing to work with our clients within the context of a holistic, flexible and customizable, goals based wealth management framework, to help achieve their desired goals.

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